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'Medtronic v. Commissioner': A Taxpayer Win on Transfer Pricing, Commensurate with Income, and Section 367 Issues

By Mark R. Martin
and
Mark J. Horowitz[1]
McDermott Will & Emery
Houston, Texas

On June 9, 2016, the U.S. Tax Court released its opinion in *Medtronic, Inc. and Consolidated Subsidiaries v. Commissioner*.[2] The Internal Revenue Service had taken issue with the transfer pricing of transactions between Medtronic, Inc. and its Puerto Rican manufacturing arm under §482 of the Internal Revenue Code.[3] Finding the IRS's application of the comparable profits method (CPM) to the transactions arbitrary and capricious, and taking issue as well with the taxpayer's comparable uncontrolled transaction (CUT) methodology, the court ultimately made its own decision as to arm's-length pricing, arriving at new allocations by making adjustments to the taxpayer's original CUT approach.

FACTS OF THE CASE

Medtronic, Inc. (''Medtronic US'') is a Minnesota corporation and the parent of an international group that is a leader in the medical technology field, a heavily regulated area where product quality is of paramount importance.[4] Medtronic US has manufacturing operations abroad, including in Puerto Rico via Medtronic Puerto Rico Operations Co. (MPROC), a Cayman Islands corporation which for U.S. tax purposes is treated as a branch of Medtronic Holding Switzerland GmbH (''Swiss Holding''), a Swiss sub-

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[1] Mark R. Martin, a partner with McDermott Will & Emery, is the head of the firm's Transfer Pricing Practice. Mark advises clients on all aspects of transfer pricing and international tax controversies, including examination, appeals, alternative dispute resolution programs and litigation. He has many years of experience handling competent authority cases and advance pricing agreement negotiations. He was previously the chair of the Transfer Pricing Committee of the American Bar Association Section of Taxation. Earlier in his legal career, he served as an attorney advisor to Judge Carolyn Miller Parr of the U.S. Tax Court.

Mark J. Horowitz, also a partner with McDermott, advises clients in transfer pricing and international tax controversy matters. He represents clients in examinations, appeals, competent authority cases, litigation, and other controversies, as well as in a full spectrum of transfer pricing-related matters, including planning and advance pricing agreements.

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[2] T.C. Memo 2016-12.

[3] All section references (''§'') are to the Code, as amended, or the Treasury regulations thereunder, unless otherwise stated.

[4] *Medtronic, Inc. v. Commissioner*, T.C. Memo 2016-112 at 13, 7–10.

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sidiary of Medtronic US.[5] During the years at issue, Medtronic US licensed intangible property necessary for manufacturing medical devices and leads to MPROC, which then distributed its products through Med USA, a Minnesota corporation within the Medtronic group performing sales and related functions.[6]

In 2010, the IRS provided Medtronic US a notice of deficiency for 2005 and 2006. Previously, following an audit of Medtronic US's 2002 tax return focusing on transfer pricing between Medtronic US, MPROC, and Med USA, Medtronic US and the IRS had entered into a memorandum of understanding agreeing to increase the royalties paid to Medtronic US by MPROC for devices and leads from 29% and 15% to 44% and 26%, respectively (the ''MOU'').[7] The MOU also set forth a profit split methodology designed to ensure that MPROC's profits were within an arm's-length range.[8] It contained an agreement that Medtronic would apply the MOU and the agreed royalty rates to 2002 and all future years, and that the IRS would respect them ''as long as there are no significant changes in any underlying facts.''[9]

In 2007, the IRS began an audit of Medtronic US's returns for 2005 and 2006, proposing increased royalty payments by MPROC to Medtronic US.[10] The IRS initially maintained that these increases were consistent with the methodology of the MOU,[11] and the adjustments were not nearly as large as those ultimately set forth in the notices of deficiency. After the case was returned from the Appeals Office to the IRS's examination function in 2010, notices of deficiency for 2005 and 2006 were issued based on a report using the CPM, setting the MOU aside.[12] After amendment, the proposed deficiencies came out to approximately $548,180,115 and $810,301,695 for 2005 and 2006, respectively.[13] In response, Medtronic US and its subsidiaries petitioned for a redetermination of the deficiency, challenging the IRS's allocations as arbitrary, capricious, and unreasonable.[14] They also sought a refund for the increased income tax Medtronic US had paid under the MOU for 2005 and 2006, asserting that their original transfer pricing position (with 29% and 15% royalty rates for devices and leads, respectively) should be respected.[15]

The transfer pricing controversy concerned two of Medtronic's business lines, Cardiac Rhythm Disease Management (''CRDM'') and Neurological (''Neuro'').[16] Both involved the design, manufacture, and sale of sensitive leads and devices to be implanted within the human body. For both lines, lapses in quality or design defects could have catastrophic effects on patients and, as a result, on Medtronic's sales, reputation, and market share.[17] For both CRDM and Neuro, Medtronic US handled research and development and clinical studies of devices, and was involved with quality control and regulatory compliance.[18] Via certain U.S. subsidiaries, Medtronic US handled the manufacturing of some component parts to be used in Medtronic's device and leads manufacturing operations abroad.[19]

MPROC, the Puerto Rico affiliate, manufactured class II and III medical devices to Food and Drug Administration standards, and was responsible for quality compliance. It had autonomy in hiring and firing its highly skilled workforce of line manufacturers and engineers, which numbered almost 2,300 in 2005 and 2006. It also had the authority to make some design and manufacturing changes.[20] MPROC proactively suggested and implemented design changes, which might require approval from the FDA or from Medtronic US.[21] For manufacturing process improvements, although FDA approval might still be required, MPROC bore the primary responsibility for implementing changes, as Medtronic US lacked the expertise needed to approve the improvements suggested by MPROC.[22]

The manufacturing process required skill, care, and time. The CRDM business line involved the manufacturing of highly sensitive devices such as bradycardia pacemakers, tachy devices, and CRT devices,[23] and MPROC was responsible for manufacturing these, as well as other devices for Neuro, in bulk while maintaining strict quality standards.[24] The device manufacturing process involved both manual and automated labor and approximately 40 steps, and it could take one to two weeks to complete a single device, with

[5] *Id.* at 13, 21.
[6] *Id.* at 20–21, 38.
[7] *Id.* at 66–67.
[8] *Id.* at 67.
[9] *Id.*
[10] *Id.* at 69–70.
[11] *Id.* at 70.
[12] *Id.*
[13] *Id.* at 71.
[14] *Id.* at 71–73.
[15] *Id.* at 71 n.4.
[16] *Id.* at 7.
[17] *Id.* at 40–46, 51–54, 59–65.
[18] *Id.* at 13–17.
[19] *Id.* at 17–20.
[20] *Id.* at 25–27.
[21] *Id.* at 26, 44.
[22] *Id.* at 44–45.
[23] *Id.* at 41.
[24] *Id.* at 41, 53.

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multiple quality inspections along the way.[25] Manufacturing Neuro leads, the wiring systems that connect implanted devices to the body itself and facilitate their interaction, was an even more labor-intensive process requiring primarily manual work.[26] Manufacturing such items could involve over 100 steps and take weeks to produce a single lead; each step required a quality review of the previous step, and there could be as many as 50 additional quality tests interspersed throughout the process.[27] In addition to its other quality control activities, MPROC maintained and utilized an intensive corrective and preventative action process to fully understand and resolve any problems that arose.[28]

Five intercompany agreements in effect during 2005 and 2006 were relevant to the case. First, Medtronic US and MPROC had entered into licensing agreements for the intangibles used in manufacturing devices and leads, giving MPROC the exclusive right to use, develop, and enjoy the intangibles for worldwide sale to customers.[29] These agreements made MPROC responsible for quality and regulatory compliance, and specified the royalty rates to be paid for devices and leads, which rates were later increased to reflect the rates agreed upon in the MOU.[30] Second, Medtronic US and MPROC had executed a components supply agreement under which MPROC would buy certain components from Medtronic US and its U.S. subsidiaries.[31] This agreement limited the potential product liability exposure of Medtronic US to the purchase price of the components it sold to MPROC.[32] Third, MPROC and Med USA had entered into a distribution agreement whereby Med USA would distribute MPROC's devices within the United States and MPROC's leads in the United States and elsewhere; this agreement protected Med USA against any product liability arising from the products.[33] Fourth, Medtronic US and MPROC had a trademark license which permitted MPROC to use Medtronic US's trademarks and tradenames for devices within the United States and its territories and possessions, and for leads throughout the world, in exchange for agreed-upon royalties.[34]

Lastly, Medtronic US, MPROC, and Medtronic Europe, S.a.r.L. (''Medtronic Europe'') entered into the ''Swiss supply agreement,'' under which Medtronic Europe was to use its manufacturing operations in Switzerland to assist MPROC in meeting any excess U.S. demand for devices, and to pay to Medtronic US the same royalties MPROC would have paid under the licensing agreements and trademark license.[35] Medtronic Europe was a Swiss corporation owned by Medtronic US's subsidiary Swiss Holding, and was treated as a branch of Swiss Holding for U.S. tax purposes.[36] It primarily manufactured devices for sale outside the U.S. market, and operated on a more limited scale than MPROC.[37]

THE COURT'S ANALYSIS

The case before the Tax Court centered around transfer pricing with respect to device and leads licensing and manufacturing, and involved two peripheral issues as well: the proper royalty rate for device manufacturing by Medtronic Europe performed under the Swiss supply agreement; and whether §367(d) provided an alternative basis for the IRS's desired allocations.[38] The parties settled other issues prior to trial.[39] Of the above-mentioned intercompany agreements, only the first four were relevant to the core transfer pricing issue. While Medtronic US, MPROC, and Med USA had separately priced these four agreements, the IRS took issue with analyzing the pricing under each agreement separately, preferring a functional analysis that viewed them together.[40] Although there were other issues in the case, the licensing agreements were the primary focus of contention.[41]

This case played out in the shadow of the MOU, which as discussed below may have given the court some cause to favor Medtronic's position, as well as supplying a possible basis for the court's own final allocations. According to the opinion, however, the MOU had no direct effect on the outcome of the case. While Medtronic contended that the very fact of departing from the terms of the MOU constituted an abuse of discretion, the court disagreed, noting that positions taken in prior years do not bind the IRS.[42] Still, it may be of interest that the IRS apparently felt the MOU sufficiently damning to seek to have it excluded from evidence, without success.[43]

The IRS's transfer pricing position was based on a CPM analysis conducted by economist A. Michael

[25] *Id.* at 42–43.
[26] *Id.* at 52.
[27] *Id.* at 53–54.
[28] *Id.* at 32–33.
[29] *Id.* at 35.
[30] *Id.* at 36–37.
[31] *Id.* at 37–38.
[32] *Id.* at 38.
[33] *Id.*
[34] *Id.* at 39.
[35] *Id.* at 39–40.
[36] *Id.* at 24, 34.
[37] *Id.* at 34.
[38] *Id.* at 71.
[39] *Id.*
[40] *Id.* at 75.
[41] *Id.* at 76.
[42] *Id.* at 88.
[43] *See* Order, *Medtronic*, T.C. Memo 2016-112 (No. 6944-11)

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Heimert, which primarily looked to MPROC as the tested party.[44] This included a value chain analysis, which broke the group's operations down into functional activities in order to assess the contributions of each entity; the IRS's economist attributed to MPROC only a single function — that of finished product manufacturing.[45] His analysis essentially treated MPROC as a contract manufacturer replaceable by other potential manufacturers,[46] and it assumed that, apart from MPROC's assembled workforce and any incremental process intangibles it might have developed since entering the licensing agreements, all the intangibles used by MPROC were licensed from Medtronic US.[47]

The Tax Court took issue with the IRS's economic analysis. It articulated particular concern regarding the IRS's decision to ascribe only a finished product manufacturing function to MPROC, which downplayed the importance of its extensive quality assurance activities and treated it as equivalent to a contract manufacturer.[48] The court also expressed concern regarding the economist's selection of comparable companies, noting important differences between their functions, capabilities, assets, and scale and those of MPROC.[49] The court further disagreed with the use of return on operating assets (''ROA'') as an appropriate profit level indicator (''PLI'') under the CPM,[50] and with the decision to aggregate the transactions embodied in the four agreements.[51] Finding the underpinnings of the economist's analysis unreasonable, the court held that the IRS's allocations were arbitrary, capricious, and unreasonable, notwithstanding the IRS's attempts to justify them under the ''commensurate with income'' (''CWI'') standard which §482 applies to transfers and licenses of intangibles.[52] With respect to that standard, the court concluded that §482 did not require the use of the CPM or any other specific method to reach a result commensurate with income.[53]

Taking into account the foregoing analysis, the court concluded that Medtronic had satisfied its burden of proving the IRS's allocations were arbitrary or unreasonable.[54] However, it did not find that Medtronic had succeeded in proving that its own proposed royalty rates for the device and leads manufacturing licenses were arm's length.[55] The court questioned Medtronic's expert's failure to make adjustments to comparable transactions to reflect the different technologies involved, and noted important differences between the licensing arrangements at issue and those involved in a previous agreement between Medtronic and Siemens Pacesetter, Inc., which Medtronic sought to use as comparable transactions under the CUT method.[56] In addition, the court believed that adjustments had not been made to account for the varying profit potentials present in the comparable transactions.[57] With respect to the trademark license, on the other hand, the court concluded that the amount paid by MPROC to Medtronic US fell above the arm's-length range and thus satisfied §482.[58]

Accordingly, the court found itself facing the task of determining the proper royalty rates itself, ultimately concluding that the CUT method should be applied to the licensing transactions with appropriate adjustments made.[59] Taking the total adjusted rate provided in Medtronic's expert's report, and making additional adjustments for know-how shared between Medtronic US and MPROC, profit potential, and the scope of the products manufactured, the Tax Court ultimately concluded that the arm's-length royalty for devices was 44% of revenue.[60] As for leads, which were not separately addressed in Medtronic's expert's analysis, the court decided that a 22% royalty rate was arm's-length, given that leads manufacturing was significantly less profitable than device manufacturing during the years at issue.[61] The similarity of those rates to the 44% and 26% figures originally agreed upon in the MOU was, the court opined, a matter of coincidence. Of course, it seems plausible that this was only ostensibly the case, and that the court may in fact have drawn its conclusions (or at least general

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(Jan. 5, 2015), https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=6456383 (noting that the IRS filed a motion in limine seeking to exclude the MOU and related documents and testimony on December 24, 2014). The motion was denied on February 3, 2015, though it appears that no separate order was published announcing this. See entry number 267 on the Tax Court's docket sheet for the case, available at https://www.ustaxcourt.gov/UstcDockInq/DocketSheet.aspx?DocketNo=11006944.

[44] *Medtronic*, T.C. Memo 2016-112 at 88–90, 92-94. One step of the analysis used Medtronic US, in its capacity as a seller of component parts to MPROC, as the tested party. *Id.* at 92.

[45] *Id.* at 89–90.

[46] *Id.* at 91–92.

[47] *Id.* at 90–91.

[48] *Id.* at 97–105.

[49] *Id.* at 109–10.

[50] *Id.* at 112–14.

[51] *Id.* at 114–16.

[52] *Id.* at 117–18, 118–20.

[53] *Id.* at 119–20.

[54] *Id.* at 118, 120.

[55] *Id.* at 129.

[56] *Id.* at 121–26. For details of the earlier agreement, see *id.* at 56–59.

[57] *Id.* at 129.

[58] *Id.* at 129–30.

[59] *Id.* at 130–32.

[60] *Id.* at 134–37.

[61] *Id.* at 138. The court arrived at the 22% figure by halving the 44% rate for devices.

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guidance) from the previously agreed figures set forth in the MOU.[62]

In closing, the court also addressed two issues peripheral to the central transfer pricing issue. First, because the IRS's adjustments had also resulted in Medtronic Europe owing more to Medtronic US with respect to devices manufactured under the Swiss supply agreement, it was necessary for the court to address the proper allocation in this context as well.[63] Because the supply agreement referenced the amount MPROC would have paid as a royalty, the court concluded that the applicable royalty rate for the devices manufactured by Medtronic Europe should likewise be 44%.[64]

Second, the notice of deficiency made alternative allocations of income from intangibles under §367(d), which would apply in the event the §482 allocations were not sustained.[65] The amount of these allocations equaled the original amount of those made under §482 for 2005 and 2006, before a later amendment increased the latter.[66] Traditionally, Medtronic had operated in Puerto Rico via two possession corporations under §936.[67] In 2002 it restructured its Puerto Rican operations, forming MPROC via capital contributions from the possession corporations, which in return received MPROC stock which was eventually transferred to Swiss Holding.[68] The IRS contended that MPROC must have received intangible assets from the possession corporations at that time, but did not identify any specific assets that were transferred, relying instead on the theory that much of MPROC's value must have derived from its acquisition of some intangibles via the contributions.[69] The court was unconvinced, especially as the intangibles used by the possession corporations were the same ones that Medtronic US licensed to MPROC under the licensing agreements.[70] Therefore it did not sustain the alternative §367(d) allocations.[71]

A PRELIMINARY MATTER: WAS MEDTRONIC'S ACTION CONSISTENT WITH REG. §1.482-1(a)(3)?

One interesting facet of the case is Medtronic's attempt to use the litigation to reach a result that was, in effect, better than the result it had before the notice of deficiency was issued. In challenging the notice of deficiency, Medtronic in fact sought to return to its pre-MOU positions, rather than the MOU-based amounts it actually paid in tax, as the proper measure of arm's-length pricing.[72] Indeed, although the order accompanying the opinion has not yet been issued,[73] it appears that Medtronic was partly successful: While the royalty rate established by the Tax Court for device manufacturing (44%) remains the same as under the MOU, the 22% rate for leads manufacturing is in fact less than the MOU's 26%.[74]

Although Reg. §1.482-1(a)(3) permits a taxpayer to use a timely filed U.S. income tax return to "report . . . the results of its controlled transactions based upon prices different from those actually charged," it provides that "section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions."[75] Here, as noted, Medtronic sought to decrease the amount of income that would be allocated to the United States, and so the regulation's prohibition would appear to conflict with Medtronic's attempt to argue that its original pricing arrangements — rather than those agreed upon in the MOU — were arm's length.

Yet the court's opinion did not address the rule laid out in Reg. §1.482-1(a)(3), and so an exploration of its relevance for the case must turn to earlier stages of the litigation. The issue was first raised after Medtronic filed an informal claim in 2009 seeking to re-establish its original 29% and 15% rates as arm's-length following the IRS's apparent repudiation of the MOU.[76] Relying on Reg. §1.482-1(a)(3), the IRS re-

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[62] *Id.*

[63] *Id.* at 139.

[64] *Id.* Medtronic Europe did not manufacture leads. *Cf. id.* at 34.

[65] *Id.* at 139.

[66] *Id.* at 139–40, 140 n.16.

[67] *Id.* at 22.

[68] *Id.* at 22–24.

[69] *Id.* at 141.

[70] *Id.* at 143.

[71] *Id.*

[72] *Id.* at 71 n.4.

[73] *Cf. id.* at 144.

[74] *Id.* at 66, 138.

[75] *Id.* Indeed, the statutory language of §482 is nothing more than a grant of discretionary authority to the Secretary of the Treasury; the statute itself confers no powers or obligations on taxpayers. *See* §482 ("the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances. . .in order to prevent evasion of taxes or clearly to reflect. . .income"); *see also* H. David Rosenbloom, *Self-Initiated Transfer Pricing Adjustments*, 46 Tax Notes Int'l 1019 (June 4, 2007) ("[S]ection 482 says nothing to the taxpayer. The section is addressed exclusively to the secretary of the Treasury, empowering him to adjust a variety of tax attributes to prevent evasion or to clearly reflect income.").

[76] *See* Memorandum in Support of Petitioner's Motion for Partial Summary Judgment at 12–13, *Medtronic*, T.C. Memo 2016-112 (No. 6944-11), *published as Medtronic Files Memorandum in Support of Partial Summary Judgment in Transfer Pricing Case*, Tax Notes Today (July 12, 2013), http://www.taxnotes.com/tax-notes-today/transfer-pricing/medtronic-files-memorandum-support-partial-summary-judgment-transfer-pricing-case/2013/07/

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jected the claim as improper.[77] Then on June 28, 2013, Medtronic moved for partial summary judgment.[78] Accompanying this motion was a supporting memorandum, which among other things took issue with the contention that Reg. §1.482-1(a)(3) might prevent the court from granting relief based on the pre-MOU prices.[79] This argument was met with an objection from the IRS, which in turn was followed by a response from Medtronic and a response to the response from the IRS.[80] Finally, the court denied summary judgment, ''conclud[ing] that there is a genuine dispute as to material facts regarding [the IRS's] examination division's determinations with respect to the transfer pricing issues.''[81] While it noted Medtronic's contention concerning Reg. §1.482-1(a)(3), the court offered no comment on the merit of that contention.[82]

It would be tempting to conclude from this that the court accepted Medtronic's argument that the regulation did not stand as a bar to Medtronic's attempts to establish arm's-length prices below those settled upon in the MOU. For example, because the court denied summary judgment only because of the presence of a genuine issue of material fact with respect to the arbitrariness of the IRS's determinations, and not because of the Reg. §1.482-1(a)(3) issue, one could argue that the court did not find the IRS's argument persuasive. Indeed, the latter issue is one upon which Medtronic needed to prevail if it was going to be able to argue for a refund in excess of the MOU, and it might seem that the court's failure to take issue with Medtronic's argument in the order, coupled with the court's silence on the matter in its opinion, should constitute a mark of implicit approval of Medtronic's reasoning.

Nonetheless, reading approval of Medtronic's rationale into the court's silence is likely not warranted. Specifically, because the court found there was a genuine issue of material fact and thus summary judgment was not appropriate, it did not need to address the legal issues in its order denying summary judgment. Likewise, while it is evident that the IRS specifically objected both to Medtronic's assertion of arbitrary decision making and to Medtronic's Reg. §1.482-1(a)(3) argument,[83] it is not clear how the parties' arguments changed and developed in the responses that followed. The court's docket list shows that both the IRS's objection and accompanying memo, as well as Medtronic's and the IRS's subsequent responses, are currently under seal and thus unavailable.[84] Ultimately, absent any pronouncement from the court itself in the opinion, it is impossible to conclude with any certainty that the court approved of Medtronic's rationale for bypassing Reg. §1.482-1(a)(3).

Still, an examination of that rationale may shed some light on why the court acted as it did in deciding on a royalty rate for leads manufacturing lower than that agreed to in the MOU (generally consistent with Medtronic's original return, as discussed in more detail below). It is worth noting that the court may have been influenced by some rather compelling equitable considerations based on the unusual procedural history of the case: Medtronic devotes several pages of its memorandum to expounding upon the unfairness of allowing the IRS to disregard the MOU while binding Medtronic to it,[85] and the court may have balked at using the voluntarily entered MOU to hobble Medtronic while leaving the IRS free to detrimentally reallocate income to Medtronic US from MPROC to its detriment.

Medtronic supported its basic appeal to fairness with reference to the prescribed procedure of the case and to the court's own institutional competence:

> Where a taxpayer has demonstrated that the Commissioner's determination is arbitrary, capricious, or unreasonable, the Court must next determine the correct arm's length results for the intercompany transactions.
>
> In this case, relying on Treas. Reg. §1.482-1(a)(3), the Commissioner has rejected any suggestion that Medtronic may show that the correct arm's length results are less than what Medtronic reported on its 2005 and 2006 returns in reliance on the Puerto Rico

12/31941. For this and other documents cited below that are available via Tax Notes, following the ''Original Source PDF'' link will yield the paginated version.

[77] *See id.* at 13.

[78] Petitioner's Motion for Partial Summary Judgment, *Medtronic*, T.C. Memo 2016-112 (No. 6944-11), *published as Medtronic Seeks Partial Summary Judgment in Transfer Pricing Dispute*, Tax Notes Today (July 12, 2013), http://www.taxnotes.com/tax-notes-today/transfer-pricing/medtronic-seeks-partial-summary-judgment-transfer-pricing-dispute/2013/07/12/31911.

[79] Memorandum in Support of Petitioner's Motion, above n. 75 at 35–40.

[80] *See* Order at 1, *Medtronic*, T.C. Memo 2016-112 (No. 6944-11) (Dec. 13, 2013), https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=6165475.

[81] *Id.* at 2.

[82] *Id.* at 1.

[83] *See* Order, *Medtronic*, T.C. Memo 2016-112 (No. 6944-11) (Oct. 17, 2013) (''respondent filed a notice of objection to question 1 and question 2 in petitioner's motion for partial summary judgment''), https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=6116002.

[84] See entries numbered 39, 40, 48, and 52 on the Tax Court's docket sheet for the case, available at https://www.ustaxcourt.gov/UstcDockInq/DocketSheet.aspx?DocketNo=11006944.

[85] Memorandum in Support of Petitioner's Motion, above n. 75 at 40–44.

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> MOU. As a matter of law, the Commissioner cannot limit unilaterally the Court's authority in this manner.
>
> . . . The regulation has nothing to do . . . with the authority of the ***Court*** to address matters under section 482. Once the Commissioner has exercised his discretion under section 482, then it is up to the Court — and ***only*** the Court — to determine the correct arm's length results, which may be greater than, less than, or even equal to the results that Medtronic reported on its original tax returns.[86]

At the same time, Medtronic sought to limit the regulation's applicability to the filing of untimely or amended returns.[87] Medtronic invoked a ''long-line [*sic*] of case law that holds that, once the IRS exercises its discretion under section 482 and a taxpayer overcomes the burden of showing the IRS's adjustment to be arbitrary, capricious, or unreasonable, the Court must determine the correct arm's-length amount.''[88]

Essentially, Medtronic shifted the focus from the restriction under the regulations to what the court is entitled to do once the IRS has challenged a taxpayer's pricing. It may be that the regulation should indeed have no bearing on the court's authority. Argumentation based on the court's inherent institutional competence, after all, is calculated to resonate particularly strongly with judges.

Yet at the same time there is something unsatisfactory in a lack of discussion of whether the court's jurisdiction under §6512(b) allowed Medtronic to seek a refund in this case. Medtronic did not simply challenge the notice of deficiency; it specifically and affirmatively requested a refund under the Tax Court's §6512(b) authority.[89] That is, does §6512(b) restrict the scope of Reg. §1.482-1(a)(3) and eliminate in the judicial context any bar on a taxpayer's ability to seek a better than as-filed result? As a counter-argument, even if the taxpayer or the IRS failed to present evidence regarding its positions and preferences regarding the ''arm's-length'' result of certain transactions, the court would presumably be free to set an ''arm's-length'' price. That is, one could view the court's authority to set prices in §482 cases as completely untethered from the restrictions of Reg. §1.482-1(a)(3).

Perhaps the answer may be found in existing case law. The cases to which Medtronic cited, while clearly establishing the Tax Court's ability to make its own allocations, do not address the precise question at issue. None of them mentions the contemporary equivalent of present-day Reg. §1.482-1(a)(3), and in none does it appear that the court used its power to adjust the allocation of income so as to provide the taxpayer with a result more favorable than what was reported on the latter's tax returns. In *Eli Lilly & Co. v. Commissioner*, *Nat Harrison Associates, Inc. v. Commissioner*, and *Ach v. Commissioner*, the court simply reached a result somewhere between the taxpayer's and the IRS's positions.[90] *Ciba-Geigy Corp. v. Commissioner* presents circumstances somewhat more similar to those at issue in *Medtronic*. There, the U.S. subsidiary of a Swiss parent challenged the IRS's efforts to reduce the amount of royalties leaving the United States.[91] Among other things, the taxpayer argued that the 10% royalties it paid were actually less than the 15% arm's-length rate, and sought to use this as a setoff against the IRS's other §482 allocations. Without discussing this issue, however, the Tax Court disagreed with its determination of what was arm's-length:

> Petitioner argues that an unrelated party would have paid a royalty of 15 percent for similar rights under the triazine patents. Petitioner therefore concludes that it is entitled to apply the difference between a royalty of 15 percent and a royalty of 10 percent as a setoff against other section 482 allocations which have been settled by the parties.
>
> After careful consideration of the record before us, we are convinced that a royalty of 10 percent constituted an arm's-length consideration for the exclusive right to manufacture and sell the triazine herbicides in the United States. We also conclude that petitioner is not entitled to an additional setoff for royalties in excess of 10 percent.[92]

While this strategy bears some similarity to Medtronic's attempts to undercut the rates established in the

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[86] *Id.* at 36–37.

[87] *Id.* at 37–38.

[88] *Id.* at 39 (citing *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 860 (7th Cir. 1988); *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172, 220–21 (1985); *Nat Harrison Assocs., Inc. v. Commissioner*, 42 T.C. 601, 617–18 (1964), *acq.*, 1965-2 C.B. 5; *Ach v. Commissioner*, 42 T.C. 114, 126–27 (1964)).

[89] Petition at 2, 69–71, 77, *Medtronic*, T.C. Memo 2016-112 (No. 6944-11), *published as Medical Technology Company Seeks Redetermination in U.S. Transfer Pricing Case*, Worldwide Tax Daily (June 24, 2011), http://www.taxnotes.com/worldwide-tax-daily/transfer-pricing-and-apportionment-issues/medical-technology-company-seeks-redetermination-us-transfer-pricing-case/2011/06/24/7836361.

[90] *Eli Lilly*, 856 F.2d at 857 (''The Tax Court's decision effectively upheld roughly half of the Commissioner's deficiency determination.''); *Nat Harrison*, 42 T.C. at 617–18, 621–22 (opting to allocate 25% of the profits from the contracts at issue to the domestic entities, rather than all or none); *Ach*, 42 T.C. at 126–27 (splitting the profits 70-30 as opposed to all or nothing).

[91] *Ciba-Geigy*, 85 T.C. at 173–77.

[92] *Id.* at 221. *See also id.* at 175. Note that the regulations at the

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MOU, one key difference is immediately apparent: Ciba-Geigy did not succeed in arguing for a rate different than the one it in fact paid.

Moreover, setoffs are a matter distinct from the affirmative deployment of §482 as prohibited by Reg. §1.482-1(a)(3). Setoffs are expressly permitted by Reg. §1.482-1(g)(4)(i), which directs the IRS, when making §482 allocations, to ''take into account the effect of any other non-arm's-length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation,'' provided the taxpayer notifies the district director as required by Reg. §1.482-1(g)(4)(ii). Although this regulation might reasonably be read as providing another limited exception to the general prohibition of taxpayer-initiated adjustments, it is distinct from the affirmative use of §482 by a taxpayer insofar as it: (1) only permits the taxpayer to seek a setoff after the IRS has made allocations; and (2) only allows amounts with respect to other transactions, which the taxpayer has established are not arm's-length, to offset the allocations made by the IRS, and does not contemplate that the taxpayer should be able to take this avenue to reach a net result better than that reflected in its filed return. Thus *Ciba-Geigy*, too, does not appear to offer direct support for Medtronic's arguments.

Nevertheless, we believe the Tax Court precedent is clear, that the court has blanket jurisdiction over the tax years at issue, and thus could determine the arm's-length pricing in a decision on a §482 issue (provided taxpayer has met its burden of showing the adjustment was arbitrary and capricious). It should be noted that an affirmative claim in the Tax Court petition or other pleading may be necessary in order to preserve the ability of the court to address this issue. In any event, it is unclear from the opinion whether the court looked approvingly on Medtronic's institutional competence theory, or whether it entertained the request for a refund on other grounds.

One other option plausibly presents itself: namely, that Reg. §1.482-1(a)(3) does not actually apply to the facts of this case. To understand this possibility, it is necessary to look at the exact process that underlay the filing of Medtronic's 2005 and 2006 returns:

> Petitioner filed timely its 2005 and 2006 tax returns using the Puerto Rico MOU. To implement the Puerto Rico MOU, petitioner first applied the original CUT royalty rates of 29% for intercompany sales of devices and 15% for intercompany sales of leads. *Medtronic determined that the appropriate arm's length royalty payments for devices and leads were $478,880,173 in 2005 and $712,761,701 in 2006.* Petitioner *then* applied the increased royalty rates (44% for devices on intercompany sales and 26% for leads on intercompany sales) and the profit split methodology in reliance on respondent's determinations set forth in the Puerto Rico MOU. After applying the profit split methodology petitioner *reported additional royalty income* on its Schedules M-3 attached to its 2005 and 2006 tax returns. Medtronic US' total royalty income from the device and leads licenses as reported in petitioner's income tax returns was increased to $663,450,013 for 2005 and to $1,109,939,529 for 2006, a total of $581,747,668 greater than what petitioner had originally determined to be an arm's-length amount.[93]

Thus, Medtronic determined arm's-length prices for 2005 and 2006 and only subsequently made separate increases in order to satisfy the terms of the MOU. Essentially, the MOU seems to have embodied an agreement that MPROC would pay a certain royalty rate and that the IRS would take no issue with this so long as no material change occurred, but it does not appear that the MOU required Medtronic to concede that the royalty rates contained therein were arm's length; on the contrary, Medtronic continued to calculate arm's-length royalties as it had done previously. While more specific information on the MOU and the 2005 and 2006 returns would be needed to make a definitive pronouncement, it is plausible that Medtronic's later attempt to reinstate its originally determined prices[94] was not, in fact, an attempt to ''apply the provisions of section 482 at will'' in violation of Reg. §1.482-1(a)(3) because no change to the prices ''actually charged'' was requested.[95]

The regulation states that a taxpayer may ''report on a timely filed U.S. income tax return . . . the results of its controlled transactions based upon prices different from those actually charged,'' but forbids the taxpayer from using ''prices different than those actually

time, though not exactly the same as their modern counterparts, did provide for setoffs; see the 1968 version of Reg. §1.482-1(d)(3) (T.D. 6592).

[93] *Medtronic*, T.C. Memo 2016-112 at 68–69 (emphases added). For background on Medtronic's transfer pricing methodology leading up to the MOU, see *id.* at 65–66.

[94] In this respect, it is key that Medtronic did not try to argue for a result that was *less* than the originally determined arm's-length price. It may be relevant also that, although the Tax Court concluded the amount paid by MPROC to Medtronic US with respect to the trademark license exceeded the arm's-length range, Medtronic did not seek, and the court did not grant, a refund with respect to the excess. *Cf. id.* at 129.

[95] Reg. §1.482-1(a)(3).

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charged'' in other contexts.[96] Here, based on the brief discussion provided in the Tax Court opinion, it seems that Medtronic was seeking approval of the prices that it did in fact charge, and only wished to eliminate the extra charges it added separately to comply with the MOU, which were adjustments made to the taxes paid but not to the actual pricing arrangements. While perhaps overly formalistic, this rationale provides an alternative ground for the court's unexplained decision to agree with Medtronic's request and set a royalty rate for leads manufacturing lower than that in the MOU.

Finally, there is the possibility that the Tax Court failed to consider the potential interaction of §6512(b) and Reg. §1.482-1(a)(3), or that the court believes firmly in the jurisdiction of the court to make these determinations without requiring taxpayers to comply with Reg. §1.482-1(a)(3).

In any event, the *Medtronic* case demonstrates that better than as-filed results can obtain in litigation in some circumstances, at least before the Tax Court. In addition, practitioners have been introduced to a potentially interesting tool which Medtronic used in effecting the MOU (reporting the MOU adjustments as Schedule M-3 adjustments), which may also be used by taxpayers as a defensive measure in similar circumstances.

A WIN FOR TAXPAYERS

Tax Court Rejects IRS's §367(d) Arguments

In the absence of a transfer of specific §936(h)(3)(B) intangibles, *Medtronic* stands for the proposition that the IRS should not be able to contend successfully that a subsidiary's or affiliate's earning of an entrepreneurial return in and of itself implies that a taxable transfer of valuable intangibles must have occurred.

In the *Medtronic* opinion, the Tax Court confirmed that the IRS must demonstrate affirmatively that taxable asset transfers occurred, rather than simply asking the court to infer that must be the case in light of the putative transferee's subsequent earning of an entrepreneurial profit.[97] The IRS had argued that, if the parties' ongoing transfer pricing were correct, then ''the value of the newly formed MPROC did not appear out of thin air, but had to be the result of a massive infusion of intangible assets at its inception.''[98]

In response, the court noted that the IRS failed to demonstrate that any particular §936(h)(3)(B) intangibles were actually transferred and rejected the IRS's argument by inference from subsequent profitability: ''[T]he gist of respondent's argument seems to be that MPROC could not possibly be as profitable as it is unless intangibles were transferred to it. We are not persuaded by this argument.''[99] In other words, the law acknowledges that it is possible for a company to begin carrying out high-value activities and bearing entrepreneurial risks, and thereby to begin earning entrepreneurial return, even in situations in which no valuable intangible property has been transferred to the company.

This reasoning and holding in *Medtronic* appear to remain relevant even under the new temporary §367 regulations, which, after all, were described by the IRS as a mere clarification of existing principles. As long as business opportunity and passive association remain established concepts, the fact remains that there still are non-taxable explanations for why an entity may come to earn entrepreneurial return as it takes on new functions and begins bearing associated risks. Thus, the IRS's arguments for the existence of taxable §367 transfers solely by way of inference from subsequent entrepreneurial profit should remain ineffective.

Discussion: Why the Court Rejected the IRS's CPM Analysis

The court rejected the IRS's application of the CPM to MPROC in favor of a CUT approach based on Medtronic's original methodology. This rejection is probably best understood by reference to the way the litigation played out. Importantly, the opinion eschewed any discussion of which method, in the abstract, would have satisfied the best method rule of Reg. §1.482-1(c), but rather confined itself to an examination of which of the two methods, as applied by the IRS and Medtronic, respectively, provided a more

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[96] *Id.*

[97] *See Medtronic, Inc. v. Commissioner*, T.C. Memo 2016-112 (June 9, 2016).

[98] *Id.*, at 141.

[99] *Id.*, at 141–42. Similarly, in a Stipulation of Settled Issues filed with the Tax Court on July 20, 2016 in *Guidant LLC v. Commissioner*, the IRS fully conceded its arguments under §367(a) and §367(d), despite the fact that the resolution of the ongoing transfer pricing issues as stipulated left more return offshore than the IRS had contended was consistent with the arm's-length standard. Again, as in *Veritas* and *Medtronic*, the realization of entrepreneurial post-restructuring returns in and of itself does not suffice to allow the IRS to construct a taxable outbound transfer capturing the post-restructuring net discounted tax flows of the restructured business.

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reasonable result.[100] Of course, the court ultimately determined that neither application provided an arm's-length result, and had to go it alone. In other words, the court did not find the selection of the CPM incorrect as a matter of law, but merely found the IRS's application of the method arbitrary and capricious.

The Tax Court is ill-equipped to undertake a full-scale transfer pricing analysis on its own. It lacks the resources, time, and personnel, as well as the institutional expertise that a true *de novo* analysis would demand. As a practical matter, when neither the taxpayer nor the IRS has conducted a satisfactory transfer pricing analysis, the court is compelled to base its own transfer pricing conclusions on the flawed analysis offered by one or both parties, focusing ''on the reasonableness of the result and not on the details of the methodology employed.''[101] Thus, it may not be the case that the court's ultimate decision to base its allocations on the CUT analysis reflected any true preference for one method over the other: It appears that the taxpayer's CUT methodology may simply have lent itself more readily to the adjustments the court wished to make. The fact that Medtronic's analysis for the most part treated the different intercompany agreements separately may have facilitated making clearly articulable and defensible adjustments without the need to undergo a complex economic analysis of vast realms of data.

The court's reasons for disfavoring the IRS's application of the CPM were numerous. For one thing, the court was skeptical of the value chain approach employed by the economist, which found no explicit imprimatur in the regulations.[102] Moreover, it found that the IRS understated both the critical role that product quality plays in the medical device industry and the potentially catastrophic effects of a product recall.[103] The court further pointed out that MPROC in particular bore the risks arising from defective or substandard devices and leads and that it had its own extensive regulatory compliance and quality assurance procedures, noting that while quality was important to all members of the Medtronic group, MPROC was responsible for the quality of the actual finished product, which would be implanted into the patient's body: ''If MPROC did not meet high quality standards, it would not matter that the rest of the company was meeting the standards.''[104] Thus the court at least partially credited Medtronic's claim that MPROC bore the economic risk associated with defective products.[105]

The court found MPROC's quality control role as the manufacturer of the finished product distinct from the role of the components manufacturers, and disagreed that MPROC could be replaced by another potential manufacturer without difficulty.[106] The court also took issue with the comparable companies proffered by the IRS, noting that their functions, scale, capabilities, and assets differed from those of MPROC, and expressing particular concern with the fact that the same companies were used as comparables for Medtronic US at a step in the analysis when the CPM was applied to the latter's sale of components to MPROC.[107]

In addition, the court took issue with the economist's use of ROA as the PLI, noting the sensitivity of ROA to the valuation of a company's assets, and the fact that the IRS's approach ignored the valuable intangible assets that MPROC acquired through the licensing agreements.[108] The court also disagreed with the IRS's decision to aggregate the covered transactions,[109] noting that the IRS's proposed aggregation approach would result in the allocation of too little profit to MPROC.[110]

Ultimately the court held the IRS's allocations arbitrary and unreasonable not because the IRS selected an inappropriate method, but because of: (i) faulty assumptions underlying the application of the method; (ii) an inappropriate selection of comparables; (iii) an improper choice of PLI; and (iv) inappropriate use of aggregation. Only the third and fourth points involve a conclusion of law with potential precedential value. With respect to the PLI, the court suggested that the ROA may generally be an inappropriate PLI in determining license fees. Likewise, although the aggregation concerns of the court appear to be more fact-based determinations, this is an interesting precedent in light of the recent purported ''clarification'' changes to Reg. §1.482-1(f). Generally, however, the result in this case offers little precedential value with respect to method selection, as most of the court's criticisms of the IRS's economic analysis are grounded in its particular application of the CPM.

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[100] *Medtronic*, T.C. Memo 2016-112 at 116–18.

[101] *Id.* at 117–18 (quoting *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 582 (1989)).

[102] *Id.* at 97.

[103] *Id.* at 97–102.

[104] *Id.* at 102–05.

[105] *Id.* at 103 & n.10.

[106] *Id.* at 106–08.

[107] *Id.* at 109–12.

[108] *Id.* at 112–14.

[109] *Id.* at 116.

[110] The court's reasoning appears to be somewhat circular: ''The resulting system profits allocated to MPROC were not reasonable because Heimert allocated an unreasonably small percentage of the profits to MPROC. Therefore, aggregation was not the most reliable means of determining arm's length consideration for the controlled transactions.'' *Id.*

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Determining the Consistency of CWI with the Arm's-Length Standard

The court was dismissive of the IRS's assertion that the commensurate-with-income standard of §482 required the court to favor the CPM over Medtronic's CUT method. Yet its holding that the CWI standard did not prevent the court from upholding the application of the CUT method to reach arm's-length allocations rested on an elaborate foundation stretching back to the Tax Reform Act of 1986. In order for the court to make its own CUT-based allocations, it had to first conclude that: (i) CWI did not effect a departure from the arm's-length standard that has traditionally formed the basis for transfer pricing allocations; and (ii) CWI permits the use of methods other than the CPM to allocate income from intangibles.

Congress's Views: The House Committee Report and the Conference Report

The Tax Reform Act of 1986 added the CWI requirement to §482: ''In the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.''[111] The legislative history behind this amendment[112] does not clearly express whether CWI was meant to remain consistent with the arm's-length standard. The Report of the Committee on Ways and Means of the House of Representatives contains certain very broad criticisms of how the arm's-length standard had been applied under the 1968 §482 regulations.[113] The report remarked that ''[m]any observers have questioned the effectiveness of the 'arm's length' approach of the regulations under section 482. A recurrent problem is the absence of comparable arm's length transactions between unrelated parties . . . .''[114] Moreover, it noted the ''fundamental problem'' that the allocation of risk and control in related-party transactions is inherently different than in other transactions:

> [A] parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets. The relationship similarly would enable the parent to adjust its arrangement each year, if it wished to do so, to take account of major variations in the revenue produced by a transferred item.[115]

It appears that Congress may have felt that adequate comparables might always be lacking for certain types of transactions, such as valuable intangibles transactions.

Conversely, other statements in the House Report suggest a narrower scope for Congress's concern. The report took issue with ''[c]ertain judicial interpretations of section 482 suggest[ing] that pricing arrangements between unrelated parties for items of the same apparent general category . . . may in some circumstances be considered a 'safe harbor' for related party pricing arrangements'' notwithstanding differences in volume, associated risks, or other factors between the transactions.[116] Congress was worried that such precedents ''may unduly emphasize the concept of comparables,'' especially ''where transfers of intangibles are concerned.''[117] The report frequently conveys the impression that the sometimes ''extreme difficulties in determining whether the arm's-length transfers between unrelated parties are comparable'' prompted Congress's addition of a CWI concept, rather than any conceptual concerns with the arm's-length standard generally.[118] Indeed, it is widely understood that the CWI legislation was in response to the IRS's losses in *Eli Lilly & Co. v. Commissioner*,[119] and *G.D. Searle & Co. v. Commissioner*.[120]

Of course, the arm's-length standard should not be taken as synonymous with the comparables-based analyses that are used to give it effect. The report's criticisms show that Congress's overriding concern was related to an overreliance on often faulty comparables, rather than directed at the arm's-length standard itself. While Congress does indeed seem to have been concerned about the adequacy of any comparables-based analysis in certain situations (such as when dealing with the transfer of high-value intangibles), there is nothing to suggest that Congress took issue with the more basic principle that transfer pricing should reflect the result that would be reached by parties dealing at arm's length; its criticisms are instead addressed toward the means used to reach a purported arm's-length result.

The Conference Report, though it treats the issues in less depth, paints a generally similar picture. Ad-

[111] Section 482, as amended by Pub. L. No. 99-514, §1231(e)(1), effective for tax years beginning after 1986.

[112] The bill in question was H.R. 3838, enacted as the Tax Reform Act of 1986, Pub. L. No. 99-514, §1231(e)(1), 100 Stat. 2085, 2563.

[113] *See* T.D. 6952, 33 Fed. Reg. 5848 (Apr. 16, 1968).

[114] H.R. Rep. No. 99-426, at 423–424 (1985), 1986-3 C.B. (Vol. 2) 1, 423–424.

[115] *Id.* at 424, 1986-3 C.B. (Vol. 2) at 424.

[116] *Id.*

[117] *Id.*

[118] *Id.* at 425, 1986-3 C.B. (Vol. 2) at 425.

[119] 84 T.C. 996, 1130 (1985), *aff'd in part*, 856 F.2d 855 (7th Cir. 1988).

[120] 88 T.C. 252 (1987).

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dressing the then-current state of the law, the report noted that the arm's-length standard supplies the usual rule but that, with respect to transfers of intangibles, ''[u]ncertainty exists regarding what transfers are appropriate to treat as 'arm's length' comparables and regarding the significance of profitability.''[121] This suggests that the changes introduced by the CWI standard were meant to address deficiencies in application of the arm's-length standard, rather than to alter the standard itself. Notably, the report contains nothing to suggest that Congress contemplated fundamentally altering the arm's-length standard.[122]

If the Tax Reform Act of 1986 did effect a repudiation of the arm's-length standard, it did so silently and without fanfare. Yet given the centrality of the arm's-length principle to U.S. transfer pricing law and the sea change that a departure therefrom would occasion, it is implausible that Congress could have meant to silently abrogate the arm's-length standard in introducing CWI. Thus, while the House and Conference Reports themselves are not entirely clear on the question, silence should resolve the matter in favor of consistency with the arm's-length standard.

The Treasury's Views: The White Paper and Beyond

The Conference Report recognized that the 1986 amendments left many issues under §482 unaddressed, and recommended that the IRS conduct ''a comprehensive study of intercompany pricing rules,'' affording ''careful consideration . . . to whether the existing regulations could be modified in any respect.''[123] The result of this prompting was the Treasury's 1988 White Paper titled *A Study of Intercompany Pricing Under Section 482 of the Code*.

The White Paper is much more definite than the legislative history in its conclusion that CWI remains consistent with the arm's-length standard. Even before the White Paper was issued, the Treasury had voiced its opinion that the 1986 amendment definitively did not mark a departure from the arm's-length standard:

> To allay fears that Congress intended the commensurate with income standard to be implemented in a manner inconsistent with international transfer pricing norms and U.S. treaty obligations, Treasury officials publicly stated that Congress intended no departure from the arm's length standard, and that the Treasury Department would so interpret the new law. Treasury and the Service continue to adhere to that view, and believe that what is proposed in this study [i.e., the White Paper] is consistent with that view.[124]

The Treasury understood Congress's unease as centered on the particular incarnation of the arm's-length standard that had developed in the caselaw, rather than on the arm's-length standard in the abstract: ''The legislative history clearly indicates Congressional concern that the arm's length standard as interpreted in case law has failed to allocate to U.S. related parties appropriate amounts of income derived from intangibles.''[125] The Treasury did not, however, take this concern to indicate any intent to repudiate the arm's-length standard, but found instead that the target of the legislation was a practice of using poor or inexact comparables in order to artificially allocate income from intangibles: ''Congress therefore decided that a refocused approach was necessary in the absence of *true* comparables.''[126] Congress's qualms concerning the misuse of comparables did not reach the heart of the arm's-length standard: ''[T]ransfer prices must be determined on the basis of true comparables if they in fact exist.''[127] Throughout, the White Paper insisted on the importance and continued vitality of the arm's-length standard in very definite terms: ''[T]here is in fact an international norm for making transfer pricing adjustments and . . . the norm is the arm's length standard.''[128]

The Treasury spoke in part out of a concern to maintain consistency with U.S. tax treaties, emphasizing the fundamental importance of the arm's-length standard: ''It is . . . clear as a policy matter that . . . the United States should continue to adhere to the arm's length standard.''[129] Taxpayers had expressed concern that, if the CWI standard was founded on something other than the arm's-length principle, this inconsistency could lead to double taxation for which U.S. tax treaties would provide no remedy.[130] This led the Treasury, in addition to its comments in and leading up to the White Paper, to include in its Technical Explanations for several treaties language stating that ''[i]t is understood that the 'commensurate with in-

[121] H.R. Rep. No. 99-841 (Vol. II), at II-637 (1986), 1986-3 C.B. (Vol. 4) 1, 637 (Conf. Rep.).

[122] *Id.* at II-637 to II-638, 1986-3 C.B. (Vol. 4) at 637–38.

[123] *Id.* at II-638, 1986-3 C.B. (Vol. 4) at 638.

[124] Notice 88-23, 1988-2 C.B. 458, 475 [hereinafter White Paper].

[125] *Id.* at 472.

[126] *Id.* (emphasis added).

[127] *Id.* at 458. *See also id.* at 473 (''In the rare instance in which there is a true comparable for a high profit intangible, the royalty rate must be set on the basis of the comparable because that remains the best measure of how third parties would allocate intangible income.'').

[128] *Id.* at 475.

[129] *Id.* at 475.

[130] *Id.*

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come' standard . . . was designed to operate consistently with the arm's length standard.''[131]

The need to ensure that tax treaties continue to function as intended provided the Treasury with a powerful incentive to read CWI as consistent with the arm's-length standard, and this motive might reasonably render the White Paper's assertions suspect. Nonetheless, the Treasury's argument is quite convincing on its own merits. By looking to what CWI actually does, the Treasury's analysis cut through the jumble of often vague statements and criticisms contained in the House and Conference Reports to reach the heart of the matter:

> Looking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do. The general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible.[132]

Further, while the concept of a ''super-royalty'' has sometimes been used in connection with CWI, the White Paper clarified that this neither mandates nor permits ''a rate in excess of arm's length rates.''[133] Thus, the Treasury concluded, CWI did not ''creat[e] a new class of royalty arrangements,'' but simply refined the application of arm's-length principles in light of ''the use of inappropriate comparables,'' which ''had failed to produce results consistent with the arm's length standard.''[134]

Tax Court Concludes That CWI Does Not Require Application of CPM

The Tax Court in *Medtronic* was similarly convinced that ''Congress intended for the commensurate with income standard to work consistently with the arm's-length standard'' and that ''[t]he commensurate with income standard does not replace the arm's length standard.''[135] Notably, the court excerpted the legislative history at length, demonstrating that even the most critical passages in the House Report are by no means inconsistent with the conclusion that Congress intended CWI to be consistent with (and not replace or supplant) the arm's-length standard. In addition to the legislative history, the court found support for its position in the White Paper and the Technical Explanations to treaties, as well as two earlier cases, *Xilinx Inc. v. Commissioner*[136] and *Altera Corp. v. Commissioner*.[137]

Having concluded that CWI is consistent with the arm's-length standard, the Tax Court in *Medtronic* was faced with another question: did CWI require or prohibit the use of any particular transfer pricing method? After all, the methods specified in the regulations all aim in their own way to reach a result consistent with what would occur in an arm's-length transaction, and so it is quite plausible that the court might have concluded that CWI, with its focus on the income attributable to the intangible, requires the use of the CPM for transactions involving the transfer or licensing of intangibles. Indeed, it appears the IRS may have argued just that.[138]

However, the court was able to find evidence in the House Report that CWI was not meant to be so restrictive:

> In requiring that payments be commensurate with the income stream, the bill does not intend to mandate the use of the ''contract manufacturer'' or ''cost-plus'' methods of allocating income or any other particular method. As under present law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property . . . . However, the profit or income stream

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[131] *See, e.g.,* Treas. Dep't, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006*, at 31, https://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf; Treas. Dep't, *Technical Explanation of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains*, at 34 (2003), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf; Treas. Dep't, *Technical Explanation of the Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Capital Gains Signed at Dublin on July 28, 1997 and the Protocol Signed at Dublin on July 28, 1997*, https://www.irs.gov/pub/irs-trty/iretech.pdf.

[132] Notice 88-23, at 472.

[133] *Id.* at 473 (''From an economic perspective, however, an unprecedented or 'super-royalty' rate may be required to appropriately reflect a relatively minor economic contribution by the transferee and achieve a proper allocation of income. . . . [T]he commensurate with income standard, in requiring a 'super-royalty' rate in order to achieve a proper allocation of income in such a case, does not mandate a rate in excess of arm's length rates. Nor does it permit taxpayers to set a 'super-royalty' rate in excess of arm's length rates.'').

[134] *Id.*

[135] *Medtronic*, T.C. Memo 2016-112 at 84–85, 119.

[136] 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

[137] 145 T.C. 91 (2015).

[138] *Cf. Medtronic*, T.C. Memo 2016-112 at 118–20.

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generated by or associated with intangible property is to be given primary weight.[139]

This passage undergirded the court's assertion that ''[t]he commensurate with income standard does not specify a specific method or a certain range of profits.''[140] The court also noted that ''[t]he section 482 regulations do not flesh out a particular test or standard to determine whether a transaction is commensurate with income.''[141] Furthermore, the court looked to the applicability of the policies underlying the 1986 amendment to the transactions involved in this case, finding that, while Congress had been concerned with the use of comparables-based methods in cases where ''vastly different products'' were used as comparables, in the instant case Medtronic ''had made transfers of similar intangibles to competitors, and the values of the intangibles were known.''[142] This justified Medtronic's choice of method and, more importantly, vindicated the court's decision to retain a CUT-based analysis for its own allocations.

Yet if the court relied on the legislative history, which it excerpted at considerable length,[143] for its conclusion that CWI did not demand the application of any particular method, another question presents itself: Were the court's ultimate allocations in line with the guidance contained in the House Report? Specifically, did the court address the report's assertion that the profit stream generated by an intangible should ''be given primary weight''?

To be sure, the court's allocations did address some profit-related issues. It made adjustments to Medtronic's original CUT analysis to properly reflect profit potential,[144] and determined a royalty rate for leads manufacturing based solely on the fact that ''[d]uring the years at issue the device operations were substantially more profitable than the leads operations.''[145] Yet much more of the court's attention was addressed — appropriately enough, given that it was applying the CUT — to comparables.[146]

The legislative history to the introduction of CWI into §482 directs that the profit stream should be accorded primary weight in determining which method to use, not in making adjustments, and there is no indication that the court even considered[147] the profit stream from the intangibles when making this choice. Thus, although the legislative history supports the conclusion that CWI does not, in the abstract, require the use of a particular method, this does appear to be a potential case where Congress intended CWI to apply to prevent the use of potentially unreliable comparables. In addition, arguably this was a case in which CWI could apply to affect either the choice of method or the application of the method, as the profits did vary significantly from year to year.

Perhaps the real reason for the court's holding that CWI did not prevent the application of the CUT method in this instance is to be sought, not in the text of the legislative history or the White Paper, but rather — just like the reason for the court's decision to base its own allocations on Medtronic's rather than the IRS's method — in the limitations of the economic analysis that was provided to the court. Having already recited a litany of defects plaguing the IRS's application of the CPM, it is highly implausible that the court could have agreed with the IRS that the commensurate-with-income language in §482 might compel it to accept the IRS's CPM notwithstanding those deficiencies.

The court thus elected to apply the CUT, even though the legislative history casts doubt on the propriety of this choice, because it had no practicable alternative. Forced to choose between a flawed CPM analysis and applying a CUT method analysis whose selection did not sit well with the discussion in the House Report, the Tax Court understandably opted for the latter.[148] As a side note, it would be interesting to see if the same result would have obtained had the IRS proposed a variable royalty based on CWI principles (a CUT adjusted or variable based on the actual profit stream generated by the intangible assets), instead of using CWI as a buttress for its CPM arguments.

Due to its flaws in this case, the CPM could not in fact yield a result commensurate with income, or an arm's-length result. This is the relevance of the fact that the CWI is in parallel with or supplements, rather than replaces or supplants, the arm's-length standard. Having concluded that the CPM analysis put forth by the IRS did not lead to an arm's-length result, and having concluded that CWI supplements the arm's-length standard — rather than replacing or supplanting it — the court could not then allow the IRS to apply the CPM under a CWI theory, let alone require its application in this or similar cases.

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[139] *Id.* at 83 (quoting H.R. Rep. No. 99-426, at 426 (1985), 1986-3 C.B. (Vol. 2) 1, 426). The reference to the contract manufacturer and cost-plus methods should not be taken to indicate that Congress felt these to be more apt for addressing CWI issues than the CPM, because the latter method would not be introduced until 1993.

[140] *Id.* at 119.

[141] *Id.*

[142] *Id.* at 118.

[143] *See id.* at 82–84.

[144] *Id.* at 135–36.

[145] *Id.* at 138.

[146] *See id.* at 130–38.

[147] *See id.* at 130–32.

[148] *Id.* at 120.

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The Tax Court correctly recognized that, given the CPM's unreliability in this case, it was critical not to issue the IRS a hunting license that would put in the crosshairs all taxpayers who apply somewhat flawed comparables, when the IRS had not yet managed to properly articulate and apply the CWI concept to such taxpayers. Fortunately, the court prevented the use of a blunt instrument (the flawed CPM analysis) as a band aid for proper analysis of the true arm's-length price commensurate with income generated.

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