How the Tax Court Can Account for Risk in Medtronic Transfer Pricing

by David G. Chamberlain

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In this report, Chamberlain explores how the Tax Court, on remand in Medtronic, can address the challenge of determining arm’s-length transfer prices when one of the related parties bears substantial risk but owns no valuable intangible property.

Table of Contents

I. Introduction ........................................... 1371
II. Transfer Pricing Rules ................................. 1374
   A. Regulations Under Section 482 .............. 1374
   B. Guidance on Risk ............................... 1376
III. Medtronic ........................................... 1377
   A. Medtronic US and MPROC .................... 1377
   B. Role of Intangible Property .................. 1379
   C. Role of Risk ..................................... 1380
   D. IRS’s Position: CPM ............................ 1383
   E. Tax Court’s Approach: CUT Method ........ 1385
   F. Eighth Circuit: Remand ....................... 1387
IV. Alternative Approaches .............................. 1388
   A. CUT Method .................................... 1388
   B. CPM (Ex Post) .................................. 1389
   C. CPM (Ex Ante) .................................. 1390
   D. Profit-Split Method ............................. 1391
V. Conclusion ............................................ 1392

I. Introduction

The ongoing court battle between Medtronic Inc. and the IRS illustrates the stakes involved in transfer pricing disputes and reflects the difficulty of accounting for the role of risk-taking in setting transfer prices.\(^1\) According to the IRS, Medtronic shifted profit from the United States to Puerto Rico, underpaying its U.S. income taxes in 2005 and 2006 by more than $1 billion.\(^2\) Allegedly, the profit shifting was achieved by minimizing the amount of royalties paid by Medtronic’s Puerto Rican subsidiary to the U.S. parent company under an intercompany license. Because the taxes Medtronic paid in Puerto Rico were negligible, the underpayment went straight to Medtronic’s bottom line.

In a June 2016 opinion, the Tax Court essentially blessed Medtronic’s transfer pricing results, finding that the company underpaid its U.S. income taxes by less than $15 million.\(^3\) On appeal, in a March 2018 decision,\(^4\) the Eighth Circuit found the Tax Court’s analysis to be lacking and therefore reversed and remanded the case for further consideration. Among other things, the Eighth Circuit instructed the Tax Court to make specific findings about the allocation of risk between the parent and the subsidiary.\(^5\) The court had scheduled further hearings for April 13, 2020,\(^6\) but the proceedings have been indefinitely postponed because of the COVID-19 pandemic.\(^7\)

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\(^1\)Medtronic Inc. v. Commissioner, T.C. Memo. 2016-112, vacated and remanded, 900 F.3d 610 (8th Cir. 2019).

\(^2\)The IRS argued that Medtronic US underpaid its income taxes by $548 million in 2005 and $810 million in 2006. It referred to this as a “classic case” of a U.S. multinational “shifting income from its highly profitable U.S. operations and intangibles to an offshore subsidiary operating in a tax haven.” 900 F.3d at 611.

\(^3\)The Tax Court determined that Medtronic US had underpaid its income taxes by only $26.7 million in 2005 and had actually overpaid its taxes by $12.5 million in 2006. 900 F.3d 610.

\(^4\)See infra text accompanying note 170 (extended quotation from case).

\(^5\)Order of the Tax Court, T.C. Memo. 2016-112 (June 25, 2019) (No. 006944-11).

Now is a good time to take stock of the case. After delving deeply into Medtronic, this report suggests how the court might go about assessing what risks each party did in fact bear and determining proper transfer prices in light of its findings.

From the outset, I should make clear that I believe the Tax Court’s decision was flawed and would result in substantial profit shifting, which transfer pricing rules are supposed to prevent. To be sure, the IRS’s analysis also had serious faults, but I believe the results of that analysis were closer to the truth. The IRS’s approach would benchmark the return-on-assets ratio (operating profit/operating assets) earned by the Puerto Rican subsidiary against the return on assets earned by independent companies that the IRS believed had comparable functions, assets, and risks. The Tax Court’s decision allowed the Puerto Rican subsidiary to earn a return on assets of 152 percent in 2005 and 218 percent in 2006. For reference in assessing whether profit shifting was likely, Medtronic as a whole earned a return on assets of only 55 percent. A company that owns few or no intangible assets like the Puerto Rican subsidiary would generally be expected to earn far less.

Transfer pricing — the pricing of business transactions between related parties — provides opportunities for multinational enterprises to shift profits into low-tax jurisdictions. For example, if a U.S. parent company licenses intangible property to a foreign subsidiary in a low-tax country, profit will be shifted if the royalty payments made by the foreign subsidiary are lower than they should be. That is, the foreign subsidiary’s taxable profits after paying the royalties will be higher than appropriate, while the taxable income earned by the U.S. parent (the royalty income) will be lower. As a result of shifting the profits from the parent to the subsidiary, the multinational group will have lowered its overall tax burden.

Let’s take a simple example. Suppose US Co, subject to 35 percent income tax, developed a valuable invention. Assume the invention required no further development effort, so any royalty received by US Co would be pure profit. US Co then licensed the invention to its subsidiary, Haven Co, which enjoys a 2 percent tax rate. Haven Co will manufacture and sell the invention worldwide. Assume Haven Co’s financial performance before paying a royalty is as shown in Table 1:

Table 1. Illustrative Example: Haven Co Financial Performance

<table>
<thead>
<tr>
<th>Sales</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total costs and expenses</td>
<td>$600</td>
</tr>
<tr>
<td>Pre-royalty operating profit</td>
<td>$400</td>
</tr>
</tbody>
</table>

An operating margin equal to 40 percent of sales, as in this example, is quite formidable and clearly indicates that the invention contains very valuable intangible property. Haven Co must pay a royalty to US Co, the developer and owner of the property. Consider two cases for setting the amount of the royalty:

**First case.** Based on the rate in a license between unrelated parties, the royalty rate is set at 15 percent of sales. The result is a $150 royalty ($1,000 sales * 15 percent). Haven Co’s taxable profit would be $250 ($400 pre-royalty profit - $150 royalty), which would be subject to $5 tax ($250 * 2 percent). US Co’s taxable income would be the $150 royalty, which would be subject to $52.50 tax ($150 * 35 percent). Total taxes would be $57.50.

**Second case.** The royalty is set at whatever rate would result in Haven Co earning taxable profit equal to 10 percent of sales, the same margin earned by an unrelated company with

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8 According to the IRS, Medtronic Puerto Rico Operations Co.’s (MPROC’s) operating profit after taking into account the adjustments required by the Tax Court was $598 million in 2005 and $925 million in 2006. Brief for the Appellant at 27 n.10, Medtronic, 900 F.3d 610 (8th Cir. 2017) (No. 17-1866). The IRS determined that MPROC’s average operating assets were $393 million in 2005 and $424 million in 2006. Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief at 32, T.C. Memo. 2016-112 (June 30, 2016) (No. 006944-11).

9 Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 242.

10 I have chosen to use the 35 percent tax rate that was applicable in the years at issue in Medtronic, but the example could just as easily use the current 21 percent rate.

11 This is an example of the comparable uncontrolled transaction method, described infra in text accompanying notes 33 to 37, which was the method used by the Tax Court in Medtronic.
similar functions and risks. The result is a $300 royalty, as would be required to ensure Haven Co earns a taxable profit of $100 ($1,000 sales * 10 percent). On this $100 of income, Haven Co would pay $2 tax ($100 * 2 percent). US Co’s taxable income would be the $300 royalty, which would be subject to $105 tax ($300 * 35 percent). Total taxes would be $107.

If the second case is the correct one, US Co succeeds in shifting $200 of profit to Haven Co by adopting the approach in the first case instead. Through profit shifting, the group saves $49.50 in taxes because more income is in Haven Co’s low-tax jurisdiction and less income is subject to high taxes in US Co’s hands.

How then do we determine which is the correct case? For all its flaws, the arm’s-length standard remains the means by which tax authorities worldwide police transfer pricing and try to combat improper profit shifting. The arm’s-length standard requires that the pricing of transactions between related parties be the same as it would be if the parties were unrelated. As described in Section II, this is the standard adopted by the United States in regulations under section 482. Further guidance on the arm’s-length standard is found in the OECD transfer pricing guidelines, which represent the consensus views of the United States and other OECD members.

There is significant tension in transfer pricing rules between the concepts of price and profit. Although a price must ultimately be determined for each related-party transaction, the determination of that price will often depend on the profit that should be earned by one or both parties to that transaction. In the earlier example, the price is the royalty rate. In the first case, the 15 percent royalty rate is set directly by reference to the rate in a transaction between unrelated parties; no consideration is given to the resulting profits earned by either US Co or Haven Co. In this report, I question whether it is appropriate to benchmark a price by reference to a purportedly comparable transaction unless profitability is also given due consideration. In the second case, an effective royalty rate of 30 percent ($300 royalty/$1,000 sales) is backed into by setting Haven Co’s profit to a specified level.

In the transfer pricing field, it is axiomatic that profits derive from a combination of functions performed, assets used, and risks assumed. When it comes to assets, a distinction should be made between intangible property and other assets such as plant and equipment. It is well accepted that intangible property is the main driver of premium profits. On the other hand, in the absence of intangible assets, the performance of operational functions and the use of tangible assets give rise only to routine profits. The second case in the example above assumes that the routine profit can be measured by the selected profit benchmark (10 percent of sales) and that the amount of the derived royalty payment constitutes the premium profit attributable to the intangible property.

While risk is often considered to be another driver of premium profit, it is too facile to simply identify risk as a driver of profit; a more nuanced analytic framework is necessary. A more nuanced approach involves recognizing that the bearing of risk affects profits in two different ways. First, it is a well-known tenet of finance and economics that increased risk normally must be compensated by an increase in the expected return from an activity. That is, for a company to agree to take on significant risk, it will generally require a higher

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12 This is an example of the comparable profits method, described infra in text accompanying notes 38 to 41, which was the method advocated by the IRS in Medtronic.


14 The regulations frame the issue in slightly different terms in different sections. In all cases, the somewhat vaguer phrase “resources employed” is used instead of “assets used.” For example, in the “1-1” regulations, guidance on conducting a functional analysis refers upfront to functions performed and resources employed (reg. section 1.482-1(d)(3)(i)), while risk is given extensive treatment but buried deeply in the regulations. For their part, the OECD transfer pricing guidelines, supra note 13, use the phrase “functions performed, assets used and risks assumed” or similar formulations more than 50 times.

15 See, e.g., Wolfgang Schoen, “International Taxation of Risk,” 68 Bull. Int'l Tax'n 280 (2014). Schoen refers more generally to “rents,” which include natural resources as well as intangible property. Transfer pricing issues involving natural resources are outside the scope of the report.

16 The distinction between routine and nonroutine contributions is introduced by the regulations governing the residual profit-split method (RPSM). See infra text accompanying notes 44 to 46. The “routine” terminology has been extended by practitioners to refer to companies that own few intangibles and bear few risks and to the relatively modest profits earned by them.

17 See, e.g., Schoen, supra note 15, passim.

18 See, e.g., Jonathan Berk and Peter DeMarzo, Corporate Finance 87-92 (2017). See also OECD transfer pricing guidelines, supra note 13, at para. 1.56.
expected rate of return than it would require for a low-risk activity. Second, the actual profits that result from a risky activity will be highly volatile depending on how the risk plays out. 19 If the risk is managed well, there may be a significant increase in profits; but if a catastrophic risk materializes, profits can quickly turn to losses.

II. Transfer Pricing Rules

A. Regulations Under Section 482

As previously noted, U.S. transfer pricing law is governed by section 482. Section 482 itself consists of only three sentences, but it is supplemented by hundreds of pages of regulations. The first sentence of section 482 gives the IRS broad authority to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among [related parties] . . . if necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such parties. Nearly identical language has been part of the code since 1928. 20 Although section 482 itself does not indicate what standard should be applied to determine if income is clearly reflected, the 1935 regulations explicitly confirmed that the arm’s-length standard should apply. 21

Without providing a comprehensive overview of the regulations under section 482, some key aspects are worth describing here. Other aspects will be introduced later in the report when they are relevant to the discussion. As noted, the regulations equate section 482’s clear reflection of income requirement with the arm’s-length standard. The regulations state the standard in unequivocal terms:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length

standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result). 22 [Emphasis added.]

Note that this standard is based on a hypothetical: A related-party transaction is arm’s length if the results are consistent with what they would have been if the transaction had occurred between independent parties. The regulation goes on to say that this hypothetical will “generally” be determined by reference to comparable transactions, 23 but — contrary to what Medtronic’s lawyers would have us believe 24 — comparable transactions are not necessary.

A central feature of the regulatory scheme is the best method rule. 25 The regulations provide specific arm’s-length methods for each type of related-party transaction. 26 In choosing which method to apply to a particular transaction, the method that provides the most reliable measure of an arm’s-length result must be applied. 27 For transactions involving intangible property (such as the Medtronic license), the regulations provide three specified methods 28:

• the comparable uncontrolled transaction method; 29
• the comparable profits method; 30 and

22 Reg. section 1.482-1(b)(1). A few definitions are needed to fully understand this provision: The term “taxpayer” refers to any person or enterprise, whether or not subject to tax; “controlled taxpayer” refers to a taxpayer that is transacting with a related party (i.e., a party under common control); “uncontrolled taxpayer” refers to a taxpayer that is transacting with an unrelated party; “controlled transaction” refers to a transaction between related parties; and “uncontrolled transaction” refers to a transaction between independent parties. Reg. section 1.482-1(i).
23 Reg. section 1.482-1(b)(1).
24 See, e.g., Pretrial Memorandum by Petitioner at 40, T.C. Memo. 2016-112 (Dec. 19, 2014) (No. 006944-11) (“The Commissioner’s methodology . . . rests on the notion that the profits to which [Medtronic US] and [MPROC] ‘should be’ entitled rule the day, rather than the actual prices that uncontrolled entities pay in the real world for similar intangible property.”) (Emphasis in original.).
25 Reg. section 1.482-1(c).
26 Reg. section 1.482-1(b)(2).
27 Reg. section 1.482-1(c)(1).
28 Reg. section 1.482-4(a).
29 Described in reg. section 1.482-4(c).
30 Described in reg. section 1.482-5.
• the profit-split method.\footnote{Described in reg. section 1.482-6.}

Further, an unspecified method may be used if it provides the most reliable measure of the arm’s-length result.\footnote{Reg. section 1.482-4(a)(4) and (d).}

The CUT method determines whether a license between related parties is arm’s-length by comparing it with one or more licenses between independent parties.\footnote{Reg. section 1.482-4(c)(1). The regulation describes the method in more general terms, such that it encompasses lump sum purchases of intangible property transferred under substantially the same circumstances.\footnote{See infra text accompanying notes 153 to 167.} Obviously, this is a very high bar. The CUT method may nonetheless be the best method if it satisfies several comparability factors.\footnote{Reg. section 1.482-4(c)(2)(ii).} Arguably, as discussed later in the critical analysis of the Tax Court’s decision in Medtronic,\footnote{Reg. section 1.482-6(c)(1).} these factors also set quite a high bar — especially the requirement for similar profit potential.\footnote{Reg. section 1.482-6(c)(3)(i)(A).}

CPM assesses whether an enterprise that engages in related-party transactions (the tested party) earns the same level of profits as independent companies that are comparable to that enterprise.\footnote{Reg. section 1.482-6(c)(3)(i)(B).} To qualify as a comparable company, a company must not itself have transactions with related parties. Because all of the comparable companies’ transactions are actually arm’s-length, the implication is that the tested party’s transactions — in aggregate — meet the arm’s-length standard if the tested party’s operating profit is consistent with the comparable companies’ operating profits. Profit levels are measured by financial ratios, such as operating margin (operating profit/revenue) or return on assets (operating profit/operating assets).\footnote{Reg. section 1.482-5(b)(4).} To be comparable, a company generally must undertake similar functions, bear similar risks, and use similar assets; however, the degree of comparability required for CPM is generally less than for other transfer pricing methods.\footnote{Reg. section 1.482-5(b)(3). More specifically, the range that is used is narrower than the full range of results in order to improve comparability by eliminating outliers. Reg. section 1.482-1(e)(2)(iii)(B). Under the regulations, taxpayers typically use the interquartile range, which is the range from the 25th percentile to 75th percentile of results. Reg. section 1.482-1(e)(2)(iii)(C).} To compensate for the relaxed comparability standards, CPM is generally applied by comparing the tested party’s results against a range of results from multiple comparable companies.\footnote{Reg. section 1.482-6(c)(3)(i)(B).}

The profit-split method evaluates whether the allocation of combined profit attributable to one or more related-party transactions is arm’s-length by reference to the relative value of each party’s contribution.\footnote{Reg. section 1.482-6(c)(3)(i)(A).} The regulations provide for two separate variants of the profit-split method: the comparable profit-split method and the residual profit-split method (RPSM).\footnote{Reg. section 1.482-6(c)(3)(i)(B).} Only RPSM is routinely used in practice.\footnote{Reg. section 1.482-6(c)(3)(i)(C).} RPSM involves a two-step process:

• First, each of the related parties is allocated income for its routine contributions, such as the functions it performs and the tangible assets it uses. This will normally involve the application of CPM, treating each party as the tested party in turn.\footnote{Reg. section 1.482-6(c)(3)(ii).} Then, any residual profit or loss associated with the parties’ nonroutine contributions, such as valuable intangible assets, is split between the parties in proportion to the relative value of those contributions.\footnote{Reg. section 1.482-6(c)(3)(iii).}

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One way of looking at the relationship between CPM and RPSM is that the former is a special case of the latter, applicable when only one of the parties makes nonroutine contributions. In this special case, all of the residual profit is allocated to the party making nonroutine contributions. If it can be shown that the party that only makes routine contributions earns an arm’s-length profit, it logically follows that the other party’s profits (or losses) are also arm’s length. This is the reason that the regulations provide that the tested party in a CPM analysis should ordinarily be the least complex party and not own any valuable intangible property.\(^{47}\)

For both the CUT method and CPM, adjustments can be made to comparable prices or profits to improve the reliability of the analysis.\(^{48}\) The regulations provide no guidance on appropriate adjustments in applying the CUT method.\(^{49}\) For CPM, guidance is provided for adjustments related to accounting methods and payment terms.\(^{50}\) In any event, as the number and magnitude of adjustments increase, a method will be considered less reliable for purposes of determining the best method.\(^{51}\)

### B. Guidance on Risk

The regulations do not provide a framework for incorporating risk in the selection and application of transfer pricing methods. Other than brief guidance in connection with cost-sharing arrangements,\(^ {52}\) the regulations address risk solely in provisions that govern comparability.\(^ {53}\) For example, in assessing whether a license agreement is comparable to a related-party license, the allocation of risk between the licensor and the licensee would be a relevant consideration. Similarly, when applying CPM, the level of risk borne by a potentially comparable company could be compared with that borne by the tested party.

The regulations provide that the determination of which related party bears a particular risk will be made by analyzing the relevant contractual terms.\(^ {54}\) The allocation of risk specified in a contract between the parties will generally be respected if it is consistent with economic substance.\(^ {55}\) In considering economic substance, the regulations provide that the following facts are relevant:

1. whether the pattern of conduct by the parties over time is consistent with the purported allocation of risk;\(^ {56}\)
2. whether the party that purportedly bears the risk has financial capacity to fund losses that might be expected to occur if the risk materializes;\(^ {57}\) and
3. the extent to which the party that purportedly bears the risk exercises managerial or operational control over the business activities giving rise to the risk.\(^ {58}\)

But what if there is no contract between the parties that specifies the allocation of a particular risk? The regulations provide that the IRS may impute a contractual agreement between the parties consistent with the economic substance of the transaction, giving greatest weight to the conduct of the parties and their respective legal rights.\(^ {59}\)

In an international context, the OECD transfer pricing guidelines contain a much more extensive treatment of the role of risk in transfer pricing. The most recent edition of the guidelines was released in 2017. It represents the culmination of several updates that came out of the base erosion and profit-shifting project undertaken by the OECD at the behest of the G-20. The BEPS project was an extremely ambitious project that sought to

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47 Reg. section 1.482-5(b)(2)(i).
48 Reg. section 1.482-1(d)(2).
49 The only relevant guidance is that, for circumstances to be considered substantially the same, there can be only minor differences that have "a definite and reasonably ascertainable effect" and “for which appropriate adjustments can be made.” Reg. section 1.482-4(c)(2)(ii).
50 Reg. section 1.482-5(c)(2)(iv).
51 Reg. section 1.482-1(c)(2)(i).
52 Reg. section 1.482-7(g)(1)(ii) and (4).
53 Comparability is covered in reg. section 1.482-1(d). Comparability of risk in particular is covered in reg. section 1.482-1(d)(3)(iii).
55 Id.

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rationalize and update a wide range of international tax rules. In the transfer pricing area, the OECD sought to make sure transfer pricing outcomes are aligned with value creation.\textsuperscript{60} The treatment of risk is an area in which the BEPS revisions were extensive.

As noted, under the U.S. regulations, the third factor for determining which related party bears a risk is “the extent to which the party that purportedly bears the risk exercises managerial or operational control over the business activities giving rise to the risk.”\textsuperscript{61} The regulation adds the following gloss: “In arm’s length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.”\textsuperscript{62} The OECD transfer pricing guidelines took this rather tepid endorsement of aligning risk with risk control functions and made it the central premise of the provisions on risk.

The OECD transfer pricing guidelines establish a six-step process for analyzing risk in related-party transactions:

1. risks must be identified with specificity;
2. the contractual allocation of risks must be determined;
3. the extent to which each party undertakes risk control functions and has the financial ability to assume risks must be determined;
4. an analysis must be undertaken to determine whether the parties actually follow the contract that allocates the risk and whether the party that assumes a risk under the contract exercises control over the risk and has financial capacity to bear it;
5. if it is found that the conditions in step 4 are not satisfied, risks must be reallocated accordingly; and
6. transfer prices must be set, analyzed, or adjusted in accordance with the proper allocation of risks (whether allocated by the original contract or reallocated under step 5).\textsuperscript{63}

The heart of the OECD’s six-step process lies in steps 4 and 5. Steps 4 and 5 essentially require that risk be allocated to a party that exercises control over activities taken to manage or mitigate the risk. If the party does not perform risk control functions, the contractual allocation of risk will be ignored and the risk will be reallocated to a party that does control these functions. According to the guidelines, control over risk involves making “decisions to take on, lay off, or decline a risk-bearing opportunity” as well as making “decisions on whether and how to respond to the risks associated with the opportunity.”\textsuperscript{64}

Obviously, this is a more elaborate approach than the U.S. regulations’ treatment of risk as a comparability factor. However, the guidance on how to actually set or adjust transfer prices (step 6) is still insufficient. Section IV of this report offers some thoughts on how this step might be undertaken.

III. Medtronic

Let us turn now to Medtronic, which shines a light on many different issues involving the allocation of risk within a multinational group of companies. This section is organized in such a way that we can work our way through the case factually and procedurally and understand the relevant issues.\textsuperscript{65}

A. Medtronic US and MPROC

During 2005 and 2006, the years at issue in the case, Medtronic was the world’s leading maker of pacemakers and a leader in the production of other medical devices. The pacemakers and other products produced by Medtronic were classified by the Food and Drug Administration as Class III medical devices. Because Class III medical devices are highly complex, implanted in the

\textsuperscript{60} For a rather jaundiced view of the BEPS project and the concept of value creation, see Mindy Herzfeld, “The Case Against BEPS: Lessons for Tax Coordination,” 21 Fla. L. Rev. 1 (2017).
\textsuperscript{61} Reg. section 1.482-1(d)(3)(iii)(B)(3).
\textsuperscript{62} Id.
\textsuperscript{63} OECD transfer pricing guidelines, supra note 13, at para. 1.60.
\textsuperscript{64} Id. at para. 1.65.
\textsuperscript{65} Unless otherwise noted, the facts of the case are drawn from the Tax Court’s opinion, T.C. Memo. 2016-112.
body, and used to sustain or support human life, they are the most highly regulated type of devices and are subject to an approval process spanning five to 10 years.

Medtronic was the parent of the Medtronic group, and Medtronic USA Inc. was its wholly owned U.S. subsidiary. (Together, these companies will be referred to as Medtronic US.\footnote{The Tax Court objected to the IRS grouping Medtronic Inc. and Medtronic USA Inc. together in its briefs because each company was involved in different transactions with MPROC. Id. at *74 n.6. Specifically, Medtronic Inc. sold components and licensed intangibles to MPROC, while Medtronic USA Inc. purchased finished products from MPROC for resale to customers. However, to keep the case description manageable and avoid undue confusion, grouping them together as “Medtronic US” is appropriate here.}) Medtronic US had responsibility for all research and development activities and for undertaking clinical studies required to obtain FDA approval. It was also responsible for manufacturing key components that were the most critical and sophisticated parts of the products.\footnote{Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 74. One of the components is the “hybrid,” which the IRS describes as the “brains of the Device”: “It contains the pacing agent, the central command microprocessor, the charging circuit, and all other electrical components that direct the operations of the Devices.” Id.} Further, Medtronic US performed all U.S. sales and marketing functions, including maintenance of crucial relationships with physicians.

Medtronic Puerto Rico Operations Co. (MPROC) was incorporated in the Cayman Islands in August 2001. The Cayman Islands is a tax haven that does not tax corporate income.\footnote{See “The Cayman Islands and Offshore Tax Issues: Hearing before the S. Comm. on Finance,” 110th Cong. 5 (2008) (statement by Michael Brostek, director, tax issues, Government Accountability Office).} Although Medtronic began manufacturing operations in Puerto Rico in the 1970s, the business was conducted by two U.S. subsidiaries that had elected preferential tax treatment under section 936. When Congress announced in 2001 that it would phase out section 936, Medtronic restructured by having these U.S. subsidiaries transfer all their assets to MPROC and having MPROC continue to conduct their businesses through Puerto Rican branches. During 2005 and 2006 MPROC paid no Puerto Rican income taxes on so-called pioneer products and paid Puerto Rican income taxes at a 2 percent rate on all other products.

Although Medtronic US was responsible for many functions in the value chain, MPROC’s sole responsibility was final product manufacturing. MPROC purchased key components and licensed intangible property from Medtronic US, used these components and intangibles to manufacture finished products, and then sold virtually all these products back to Medtronic US for sale to end-customers.\footnote{MPROC also had a very small amount of sales to third parties in Central and South America and the Caribbean. See, e.g., Pretrial Memorandum of Petitioner, supra note 24, at 16. T.C. Memo. 2016-112 at *102. In its opening brief, the IRS writes: “Every Medtronic employee was focused on quality, which included quality product designs, quality manufacture of components and finished products, quality service to customers, and quality collaboration with outside organizations.” Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 11.} MPROC’s manufacturing operations were sophisticated, involving both intensive manual work by line employees (approximately 70 to 75 percent of a workforce of nearly 2,300 employees) as well as higher-level efforts of trained engineers who were, among other things, “involved with project implementation, technology harvesting, and process development.”

MPROC also undertook a wide range of quality control activities, which the Tax Court described in great detail. In its pretrial briefs, Medtronic argued that manufacturing quality was far and away the most important value driver in its business.\footnote{T.C. Memo. 2016-112 at *102. In its opening brief, the IRS writes: “Every Medtronic employee was focused on quality, which included quality product designs, quality manufacture of components and finished products, quality service to customers, and quality collaboration with outside organizations.” Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 11.} The Tax Court largely accepted this argument, stating:

Respondent [the IRS] does not place enough emphasis on the importance of quality in the industry. The final product is the key to success. Product quality is the foundation for which implantable medical devices can be successful. . . . A company can have a strong sales force and a creative marketing department, but these will not make a difference if the underlying product is unsafe and ineffective.\footnote{See, e.g., Pretrial Memorandum of Petitioner, supra note 24, at 16. T.C. Memo. 2016-112 at *102.}

In actuality, the IRS did put a significant emphasis on quality in its briefs. However, it considered quality more broadly than just finished product manufacturing and emphasized Medtronic US’s role in ensuring quality on a companywide basis.

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Opening Brief, supra. 66

66. MPROC was also involved in different transactions with MPROC. Id. at *74 n.6. Specifically, Medtronic Inc. sold components and licensed intangibles to MPROC, while Medtronic USA Inc. purchased finished products from MPROC for resale to customers. However, to keep the case description manageable and avoid undue confusion, grouping them together as “Medtronic US” is appropriate here.

67. Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 74. One of the components is the “hybrid,” which the IRS describes as the “brains of the Device”: “It contains the pacing agent, the central command microprocessor, the charging circuit, and all other electrical components that direct the operations of the Devices.” Id.

As noted at the outset of this report, the Tax Court’s decision resulted in the level of MPROC’s profits being extremely high compared with other potential standards. Because the Tax Court relied on a transfer pricing method that did not benchmark profits directly, it is impossible to know conclusively whether the court attributed MPROC’s profitability primarily to the value of its functions concerning manufacturing quality or to another factor, such as risk. It is worth noting that manufacturing quality and product liability risk are closely correlated. The Eighth Circuit concluded that risk was the most important factor in the Tax Court’s decision.

The transactions that were central to the Tax Court case were three agreements under which Medtronic US licensed specific intangible property to MPROC for use in its manufacturing business. These agreements would result in MPROC earning profits that could vary significantly depending on how risks played out. The three licenses were a devices license, a leads license, and a trademark license. (Devices and leads were the two types of products that MPROC manufactured.) As initially structured, all three licenses provided for MPROC to pay Medtronic US royalties as a percentage of intercompany sales. The rates were 29 percent under the devices license, 15 percent under the leads license, and 8 percent under the trademark license.

The rates under the devices license and the leads license were subsequently increased (to 44 percent and to 26 percent, respectively) as a result of an agreement between Medtronic and the IRS during an audit of Medtronic’s 2002 tax return. These rates were based on a profit-split analysis and were adjusted when the profit split fell outside of a specified range. Medtronic filed its 2005 and 2006 tax returns consistently with the 2002 agreement, but it argued in the Tax Court that the original rates were arm’s length — and the rates in the 2002 agreement were not — and therefore asked for a refund of overpaid taxes.

B. Role of Intangible Property

Intangible property was extremely important to Medtronic’s success. In its filings with the SEC for 2006, Medtronic identified its top strength as “broad and deep technological knowledge of microelectronics, implantable devices and . . . related areas, as well as a tradition of technological pioneering and breakthrough products that not only yield better medical outcomes, but more cost-effective therapies.”

Intangible property will generally be reflected in high levels of R&D expense. In 2005 and 2006 Medtronic’s R&D expense was equal to nearly 10 percent of its revenue, virtually all of it incurred by Medtronic US. To be sure, R&D activity does not necessarily produce valuable intangible property — it is the epitome of a risky activity that may result in failure. However, Medtronic’s industry-leading profit margins make clear that its R&D was successful and that its intangible assets were very valuable.

External analysts also identify innovation and intellectual property as the dominant value drivers in the medical device industry. A March 2007 report by the U.S. International Trade Commission is representative. In the chapter titled “Principal Competitive Factors,” the first factor identified is “innovation, research and development, and intellectual property.” The report states:

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73 See supra text accompanying notes 8 to 9.
74 See infra quotation accompanying note 170.
75 The parties also entered into two other agreements: a components supply agreement and a distribution agreement. Both agreements allowed Medtronic US to earn a “routine” margin on its activities (i.e., supply of components to MPROC and sale of products to end-customers). The Tax Court noted that IRS experts did not challenge the arm’s-length nature of these transactions. That is essentially correct if it is understood that the IRS intended the royalty adjustments to compensate Medtronic US for intangibles related to components and marketing as well as to the intangibles explicitly covered by the licenses. See Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 143-144. For purposes of this report, those complexities can be ignored.
76 The trademark royalty applied to total sales of both devices and leads.
77 This was the so-called memorandum of understanding.
78 Medtronic Inc. Annual Report (Form 10-K), at 1 (June 28, 2006).
79 In 2006, on net sales of $1.292 billion, Medtronic spent $1.113 billion on R&D (9.86 percent); in 2005, on net sales of $1.055 billion, it spent $951 million on R&D (9.46 percent). Id. Exhibit 13 at 34. According to the IRS, MPROC’s share of Medtronic’s R&D spending was a fraction of 1 percent (0.2 percent). Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 32.
81 Id. at 2-1.
Innovation and a strong commitment to R&D are principal competitive factors for this industry and were the factors most frequently cited as critical to firm success. The medical device industry is R&D-intensive, driven by constant innovation and short product life cycles.

Medtronic US was responsible for virtually all R&D activity and owned virtually all the intangible property within the Medtronic group. MPROC’s contribution to R&D was limited to input on whether Medtronic US’s designs could be manufactured at commercial scale.

Indeed, in its Tax Court briefs, Medtronic emphatically denied that MPROC owned any intangible assets when it was formed in August 2001, a mere four years before the years at issue. As noted earlier, although Medtronic had manufacturing operations in Puerto Rico beginning in 1974, those operations were conducted by U.S. subsidiaries of Medtronic Inc.

MPROC came into existence in 2001 when these subsidiaries transferred all their assets to MPROC in a transaction that was tax free under then-applicable law. That is, the transfer was tax free regarding tangible assets used in an active trade or business. If these assets had included any intangible assets, the transfer of those assets would have been taxable under the deemed royalty rule of section 367(d). It is for this reason that Medtronic emphasized that all intangibles were owned by Medtronic US and not transferred to MPROC. This would necessarily include any know-how concerning the Puerto Rican manufacturing operations.

Nonetheless, Medtronic did argue in its brief to the Eighth Circuit that MPROC possessed “self-developed know-how and intellectual property obtained via the Licenses.” The Tax Court appears to have accepted this argument regarding the licensed intangibles. As for know-how, any incremental know-how developed between August 2001 and 2005-2006 would be minor compared with manufacturing know-how developed between 1967 and 2001 that Medtronic conceded belonged to Medtronic US. As for obtaining intangibles through the licenses, this argument does not stand up to scrutiny. The valuable intangibles that were licensed continued to belong to Medtronic US. The intangible that MPROC owned was the license itself. A license can have value if, because of changes in circumstances, the royalty rate specified in the license proves to be lower than would be negotiated if the changed circumstances were taken into account. Medtronic has not argued that circumstances changed between August 2001 and 2005-2006, so no significant value should be attributed to the license.

C. Role of Risk

Risk played a central but elusive role in Medtronic. Neither Medtronic nor the IRS made explicit arguments that satisfactorily explained how their transfer pricing methods addressed

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82 Id. at 2-1 to 2-2 (citations omitted).
83 Absent a contract giving MPROC partial ownership rights in the intangibles developed, ownership of the intangibles — and therefore the right to earn premium profits from exploiting them — belonged solely to Medtronic US because it was the legal owner of the IP rights and had primary control over the use of the intangible property. Reg. section 1.482-4(f)(3).
84 See Section III.A.
85 Transfers of property to a domestic corporation controlled by the transferor in exchange for stock are generally tax free under section 351. However, under section 367(a), transfers to a foreign corporation (including a Puerto Rican corporation) do not qualify for tax-free treatment unless specific exceptions apply. In 2001 section 367(a)(3) provided such an exception for transfers of tangible assets used in the active conduct of a foreign trade or business. (This exception was repealed at the end of 2017.) Medtronic’s transfers of business assets qualified for this exception, and therefore the transaction was tax free.
86 Section 367(d) provides that the transfer of intangible property to a foreign corporation in exchange for stock will be treated as though the transferor had sold the intangible property for a series of annual payments that are commensurate with the income attributable to the intangible. The regulations in effect in 2001 contained an exception for transfers of “foreign goodwill and going-concern value,” but Medtronic did not rely on that exception.
87 The IRS had made an alternative argument to the effect that if the court found that the royalties were arm’s length, MPROC’s high level of profitability indicated that Medtronic US must have transferred intangibles to MPROC under section 367(d). It is entertaining to read Medtronic waxing eloquent in its pretrial briefs about how Medtronic US owned all valuable intangibles even as it was trying to defend MPROC’s impressive profits. See, e.g., Pretrial Memorandum of Petitioner, supra note 24, at 59.
88 The definition of intangible property in the code specifically includes know-how. See section 367(d)(4)(A). The predecessor to section 367(d)(4), effective before tax reform in late 2017 under the Tax Cuts and Jobs Act, was section 936(h)(3). Although the TCJA made some changes to the provision (such as explicitly including goodwill in the definition of intangible property), there was no change to the language regarding know-how.
89 Brief for the Appellee at 34, Medtronic, 900 F.3d 610 (8th Cir. 2017) (No. 17-1866).
90 T.C. Memo. 2016-112 at *114.
91 See reg. section 1.482-4(f)(3)(ii) and (ii), Example 1.
risk. The Eighth Circuit summed up Medtronic’s argument as being that MPROC was entitled to the impressive profits it earned because it bore “the lion’s share of potential liability.” Because the Tax Court failed to make an explicit finding about the nature and extent of risks borne by MPROC, the Eighth Circuit specifically demanded that the Tax Court do so on reconsideration of the case.

One of the most significant risks in the medical device industry is the risk of product liability claims and product recalls as the result of product defects. Echoing Medtronic’s argument, the Tax Court observed that MPROC’s manufacturing process “is very different from manufacturing electronic equipment such as a cell phone. If a cell phone malfunctions, the consumer could be inconvenienced; if a device or lead malfunctions, the consumer could die.”

Although the Tax Court focused on MPROC’s role as manufacturer, defects in the design of products — which were the responsibility of Medtronic US — appear to be a significantly greater source of product liability in the medical device industry. According to the IRS, the two major product liability cases faced by Medtronic in the early 2000s (the Fidelis leads and the Marquis devices) were both the result of design defects. Indeed, although the claim was disputed by the Tax Court, the IRS maintained that both products “met all manufacturing specifications.”

In its briefs, Medtronic placed great emphasis on the argument that MPROC bore primary responsibility for product liability risks “as the manufacturer directly liable under common law.” Medtronic also emphasized that MPROC agreed to be “liable for all costs and damages arising from recalls and product defects” in the devices and leads licenses.

On remand, the Tax Court should address the following issues regarding the magnitude and allocation of product liability risk:

- The magnitude of Medtronic’s potential liability. Medtronic’s liability is limited by the federal preemption doctrine, which precludes injured patients from pursuing state law claims for negligence in design if the product received FDA approval. Notably, a “narrow category” of claims for failure to manufacture products according to FDA-approved specifications are not precluded. The court needs to determine whether the potential liability was truly in the billions of dollars, as Medtronic asserted, or significantly less.
- The common law doctrine of apparent manufacturer. Even though manufacturing defects are not subject to federal preemption, Medtronic US would almost certainly be fully liable under this doctrine because the products are sold under its trademark, are based on its designs and lack markings indicating MPROC is the manufacturer.
- The effect of common law principles of indemnity and contribution. Absent contractual indemnification, product liability is apportioned among parties in the distribution chain in proportion to their culpability. So, for example, Medtronic US would bear full liability for any

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92 In its Tax Court briefs, the IRS stated: “Although not explicitly, petitioner appears to resort to arguing that Medtronic’s product liability risk can justify some undefined portion of petitioner’s profit allocation to MPROC.” Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 169-170 and 265.
93 900 F.3d at 611.
94 See infra quotation accompanying note 170.
95 T.C. Memo. 2016-112 at *105.
96 Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 127.
97 Id. at 126-127.
98 Id. The Tax Court disputed this characterization, finding that the “Fidelis quality problems involved both design and manufacturing.” T.C. Memo. 2016-112 at *64. However, in product liability litigation over the Fidelis leads, the district court concluded that even if MPROC’s welding was at fault (as alleged by the plaintiffs), the welding was compliant with the FDA’s good manufacturing practices and quality system regulation. In re Medtronic Inc. Sprint Fidelis Leads Products, 592 F. Supp. 2d 1147, 1157-1158 (D. Minn. 2009).
100 Id.
101 In re Medtronic, 592 F. Supp. 2d at 1150-1152.
102 Id. at 1152 (quoting Stevens v. Pacesetter Inc., No. 3:07-cv-3812 (D.S.C. 2008)).
103 Petitioner’s Revised Redacted Simultaneous Opening Brief, supra note 99, at 116.
104 See Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 266-267 (citing Torres v. Goodyear Tire & Rubber Co., 786 F.2d 939, 942 (Ariz. 1990); and Restatement (Third) of Torts: Product Liability section 14, cmt. d).
105 See id. at 268-269 (citing Restatement (Third) of Torts: Apportionment of Liability sections 22 and 23).
SPECIAL REPORT

manufacturing defect in the components supplied by it.

- Enforceability of MPROC’s contractual assumption of liability under Minnesota law. The IRS argued that the intercompany agreements between Medtronic US and MPROC failed to meet the relevant standard. 106

- Whether MPROC’s assumption of liability had economic substance under the section 482 regulations. For a contractual term purporting to allocate risk to be accepted for transfer pricing purposes, the following considerations are relevant: (1) pattern of conduct; (2) financial capacity to fund potential losses; and (3) managerial or operational control over risk management activities. 107 The IRS argued that Medtronic’s allocation of risk to MPROC failed all three considerations. 108

Regarding controlling risk management activities, as discussed in Section II, the OECD transfer pricing guidelines now give special priority to this factor in determining the allocation of risk between related parties. 109 I would argue that a detailed analysis of this factor is appropriate under the existing regulations as well, but I recognize that the Tax Court may not give it a prominent role in the risk assessment. 110

In Medtronic’s case, MPROC performed quality control activities for finished product manufacturing, subject to standard-setting and oversight by Medtronic US, but it had no control at all over other significant sources of risk. These other risks included risks related to development and design, protection and defense of patents, manufacturing of components, and liaison with doctors and hospitals during the device implantation process.

The transfer pricing guidelines do not explicitly explain the theoretical basis for requiring that risks be allocated to the risk controller, but professor Wolfgang Schoen has identified one potential basis:

An arm’s length argument might run as follows: the party which is not able to control the risk would have to seek compensation for assuming the risk which would be higher than the respective cost incurred by the other party — the “least cost-avoider” — in the first place. 111

Schoen ultimately rejects this rationale, writing:

On the contrary, a great deal of contractual instruments between independent parties are meant to shift risk away from the person closest to the risk in order to reach efficiency. One such major case is insurance (for example, car insurance or health insurance): while it is evident that the insured person is much closer to the risk and controls it in many cases, to a limited extent, the economic benefit of diversification has led to the establishment of insurance companies all over the world who hardly control any risk they insure. 112

This argument has some superficial appeal. However, on closer reflection it is clear that MPROC did not behave like an insurance company in any respect. It had no expertise in insurance activities and did not have any means of pooling or diversifying risks. 113 This is likely to be the case in most related-party contexts, undermining Schoen’s argument significantly.

Regarding the financial capacity to bear risk, Schoen has also addressed this concern — in a line of argument that is much stronger, in my view. He points out that if a risk materializes that gives rise to costs that are greater than those that the purported risk-bearer can bear, the risk and costs will automatically “fall back on the insured person.” 114 In Medtronic’s case, MPROC’s entire

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106 See id. at 271 (citing, inter alia, National Hydro Systems v. M.A. Mortenson Co., 529 N.W.2d 690, 694 (Minn. 1995)).
108 Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 273-277.
109 See supra text accompanying notes 62 to 64.
110 See infra text accompanying note 170.
111 Schoen, supra note 15 (text accompanying Schoen’s note 76).
112 Id. (text accompanying Schoen’s note 79).
113 The IRS made the same argument in its briefs. See Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 275-276.
114 Schoen, supra note 15, at section 4.2.2.3 (capacity to bear risk).
net equity (assets minus liabilities) at the start of 2005 and 2006 was $410 million and $480 million, respectively. If the Tax Court accepts Medtronic’s claim that the potential liability is in the magnitude of billions of dollars, this level of capitalization calls into question the economic substance of MPROC’s purported risk bearing.

Ultimately, despite skepticism about many of Medtronic’s claims, I am agnostic as to the magnitude and allocation of risk in Medtronic’s case. There is a great range of possible findings. What is important is that the Tax Court be able to tailor its resolution of the transfer pricing issues to whatever findings it makes. As noted in Section II, neither the U.S. regulations nor the OECD transfer pricing guidelines offer much help to the Tax Court in this regard. Hopefully, the observations in Section IV provide some assistance.

D. IRS’s Position: CPM

1. Description of position.

In the Tax Court proceedings, the IRS argued that the amount of the total royalties MPROC paid to Medtronic was grossly understated — by more than $700 million in 2005 and more than $1.1 billion in 2006. In arriving at this conclusion, the IRS applied CPM. To apply CPM, the IRS aggregated all the transactions between Medtronic US and MPROC and compared the bottom-line operating profit earned by MPROC against the profits earned by companies it considered comparable to MPROC. The IRS calculated the level of profits MPROC should have earned under the arm’s-length standard by multiplying the average value of MPROC’s operating assets by the median return on assets earned by these comparable companies.

Typically, it is necessary to aggregate all of a company’s transactions within a line of business to apply CPM because the operating profits from that line of business must be compared against the operating profits earned by comparable companies. In MPROC’s case, there was only one line of business: It purchased components from Medtronic US, used those components and intangible property licensed from Medtronic US to assemble final products, and then sold the finished product back to Medtronic US. Because the IRS did not believe sufficiently comparable transactions could be found for all these transactions but did believe reasonably comparable companies could be found for the line of business, it chose CPM as the transfer pricing method under the best method test. MPROC was chosen as the tested party to apply CPM because it performed fewer functions, owned no valuable intangible property, and bore fewer risks than Medtronic US.

IRS expert Michael Heimert used Compustat to find comparable companies. Compustat is a commercially available database that compiles information filed with the SEC by public companies. Heimert narrowed the set of potential companies to those identified by standard industrial code 384 (surgical, medical, and dental instruments and supplies). He then applied various quantitative and qualitative screens to identify 14 companies that he considered most comparable to MPROC. The companies in Heimert’s set were diversified medical device manufacturers, many of which had full-fledged research and marketing operations as well as manufacturing.

Heimert selected return on assets as the profit-level indicator because MPROC’s operations were very dependent on manufacturing assets. The range of results were:

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115. Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 274.
116. See id. at 151. The IRS determined that MPROC should have earned an operating profit of $110.5 million in 2005 and $110.4 million in 2006 instead of the $828 million it earned in 2005 and the $1.273 billion it earned in 2006. Id.
117. For a description of CPM, see supra text accompanying notes 38 to 41.
118. For the Tax Court’s description of the IRS’s CPM analysis, see T.C. Memo. 2016-112 at *89-97. In subsequent footnotes, I will cite the IRS’s own description of the analysis from its opening brief.

119. Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 147.
120. Id.
121. Id.
122. Id. at 147-148.
123. Id. at 148.
124. Id. at 150.
125. Id. at 150-151.
• 2005: lower quartile = 22 percent; median = 28.1 percent; upper quartile = 39.9 percent.
• 2006: lower quartile = 21.7 percent; median = 26 percent; upper quartile = 39.3 percent.

Because MPROC’s results were significantly above the upper quartile, Heimert based his proposed adjustment on the median results. Consistent with CPM, Heimert calculated total royalty amounts for each year rather than directly calculating royalty rates. These amounts translated to the following royalty rates (as a percentage of end customer sales and as a percentage of intercompany sales):

• 2005: 75.2 percent (intercompany sales); 49.4 percent (end-customer sales).
• 2006: 65.2 percent (intercompany sales); 58.9 percent (end-customer sales).

In comparing these royalty rates to those adopted by the Tax Court, keep in mind that the IRS’s rates combine the technology and trademark licenses. That is, for comparison, the Tax Court’s rates for intercompany sales (30 percent for devices and 15 percent for leads) should be increased by 8 percentage points to reflect the trademark license.

The IRS argued that Heimert’s analysis properly accounted for MPROC’s bearing of risk, including product liability risk, because the comparable companies were integrated medical device manufacturers that bore similar risks.

2. Critical analysis.

There are several valid criticisms of the IRS’s position. Even though the regulations specifically authorize use of CPM for intangible property transactions, there is serious question whether CPM can ever be a reliable method for intangible property transactions when the licensee agrees to pay a royalty stated as a fixed percentage of sales.

First and foremost, CPM is not suitable for benchmarking the returns of a tested party that bears significant risk. Under CPM, the tested party must earn a relatively fixed return (for example, a return on assets within a narrow range) regardless of how actual risks play out. To ensure the tested party earns a fixed return — approximately $110 million each year in MPROC’s case under the IRS’s analysis — the actual royalty rate must be allowed to fluctuate from year to year.

As actually structured, the licenses at issue in the case required MPROC to pay royalties at fixed rates as a percentage of sales. Under the regulations, the IRS must respect the structure of the taxpayer’s transactions unless the structure lacks economic substance. Even if it were determined that MPROC did not bear any product liability risk, this fixed-rate royalty structure in itself resulted in MPROC bearing substantial risk. In particular, if MPROC could not achieve sufficient operating margins because of higher-than-expected costs or lower-than-expected sales, the fixed-rate royalty could result in MPROC incurring losses.

Another fundamental criticism of the IRS’s position is also valid. The Tax Court criticized the IRS’s selection of comparable companies on grounds that the companies “own all of the intangibles and bear all of the risks throughout the entire value chain” rather than solely performing manufacturing functions. The IRS’s expert argued that this defect would have the effect of overstating the return MPROC should earn and is therefore conservative, but the court rightly rejected that argument. Although the argument would tend to be true due to comparable companies’ ownership
of valuable intangibles, the arm’s-length return would not necessarily be overstated because the comparable companies may have earned lower returns as a result of risks materializing. The IRS was between a rock and a hard place here: If it had chosen companies that solely performed manufacturing functions, it would have been accused of inappropriately treating MPROC as a contract manufacturer rather than a risk-bearing licensee, a smear that has lost the IRS many cases throughout the years.\footnote{134}

E. Tax Court’s Approach: CUT Method

1. Description of opinion.

There are three steps in a court’s review of an IRS adjustment under section 482. First, the court considers the taxpayer’s challenge to the IRS’s position. The IRS’s position is presumptively correct, and the taxpayer bears the burden of proving that it is arbitrary, capricious, or unreasonable.\footnote{135} If the taxpayer carries this burden, the court then considers whether the taxpayer’s own position satisfies the arm’s-length standard.\footnote{136} If the court finds that neither side is correct, the court finally must fashion its own resolution to the case.\footnote{137}

The Tax Court did indeed find that the IRS’s adjustments were arbitrary, capricious, or unreasonable and therefore set them aside.\footnote{138} Having rejected the IRS’s position, the Tax Court turned to Medtronic’s analysis. The court decided that no adjustment should be made to the trademark license, leaving only the devices and leads licenses for closer consideration.\footnote{139}

Medtronic had argued that the best comparable for a CUT method analysis of the devices and leads licenses was the so-called Pacesetter agreement. This was an agreement between Medtronic and one of its competitors, Siemens Pacesetter, which was a cross-license that had been entered into in settlement of several lawsuits involving patent, antitrust, and employment issues.\footnote{140} The royalty rate in the agreement was 7 percent, but Medtronic’s expert made some adjustments and argued that the arm’s-length rate was between 16 and 17 percent.\footnote{141} Although the Tax Court accepted both the conclusion that the CUT method was the best transfer pricing method and that the Pacesetter agreement was the best comparable,\footnote{142} the court rejected Medtronic’s position because the adjustments made by Medtronic were insufficient and because royalty rates for devices and leads were not separately determined.\footnote{143}

Having rejected the positions of both the IRS and Medtronic, the Tax Court turned to the task of fashioning its own CUT method analysis. The court calculated a royalty for the devices license (stated as a percentage of end-customer sales) as follows:

- Use the 7 percent royalty from the Pacesetter agreement as the starting point.\footnote{144}
- Double the royalty to 14 percent to account for the fact that the intercompany licenses were exclusive whereas the Pacesetter agreement was not.\footnote{145} This is the same adjustment Medtronic made, but neither Medtronic nor the court explained how it was derived.
- Add 3 percentage points to account for the fact that the intercompany licenses gave MPROC access to improvements made by Medtronic US whereas the Pacesetter agreement did not.\footnote{146} This was also an adjustment that Medtronic had made, but again no explanation was provided by either

\footnotesize{\textsuperscript{134} For discussion of the contract manufacturer line of cases, see Reuven S. Avi-Yonah, “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation,” 15 Ires. Tax Rev. 89, 117-127 (1995). Even though the IRS bent over backward to avoid being accused of inappropriately treating MPROC as a contract manufacturer, Medtronic did not hesitate to characterize the IRS as doing just that. See Brief for the Appellee, supra note 89, at 10. \textsuperscript{135} T.C. Memo. 2016-112 at *85 (citing Sundstrand Corp. v. Commissioner, 96 T.C. 226, 353-354 (1991)). \textsuperscript{136} Id. at *86-87 (citing Eli Lilly & Co. v. Commissioner, 856 F.2d 855, 860 (7th Cir. 1988)). \textsuperscript{137} Id. at *87 (citing Veritas Software Corp. v. Commissioner, 133 T.C. 297, 318 (2009)). \textsuperscript{138} Id. at *118. \textsuperscript{139} Id. at *132.}

\footnotesize{\textsuperscript{140} Id. at *56-59. See also Respondent’s Revised Redacted Second Amended Simultaneous Opening Brief, supra note 8, at 256 (referring to antitrust and employment issues). \textsuperscript{141} T.C. Memo. 2016-112 at *123-*124. \textsuperscript{142} Id. at *133-*134. \textsuperscript{143} Id. at *124-*130. \textsuperscript{144} Id. at *134. \textsuperscript{145} Id. \textsuperscript{146} Id.
Medtronic or the court as to how it was derived.

- Add 7 percentage points to account for Medtronic US’s provision of know-how to MPROC. The Tax Court explained that the provision of know-how was “equivalent” to exclusivity and therefore made an adjustment of the same magnitude. 147
- Add 3.5 percentage points to account for differences in profit potential. The Tax Court explained that it considered exclusivity and know-how to have “a greater impact on the value of the licenses” than profit potential and therefore made an adjustment that was half of the adjustment for each of those other factors. 148
- Add 2.5 percentage points to account for the greater scope of products (that is, neurological as well as cardiac) in the intercompany licenses. Because Medtronic’s neurological business was not as large as the cardiac business, the Tax Court concluded that an adjustment equal to roughly one-third of the starting royalty was appropriate. 149

As a result of these adjustments, the Tax Court concluded that the arm’s-length royalty for the devices license was 30 percent of end-customer sales (the equivalent of a 44 percent royalty on sales to Medtronic US). 150

The Tax Court noted that Medtronic’s original licenses provided for a 29 percent royalty for devices and roughly half that amount (specifically 15 percent) for leads. Based on purported differences in the profitability of devices and leads, the court concluded that the royalty rates for leads should be half those for licenses (that is, 15 percent of end-customer sales or 22 percent of intercompany sales). 151

As previously noted, the Tax Court did not make a finding regarding the level of risk borne by MPROC. There was no discussion of risk in connection with the CUT method analysis, either.

The implicit assumption would seem to be that the level of risk borne by MPROC was comparable to that borne by Pacesetter.

2. Critical analysis.

As noted at the outset of this report, the Tax Court’s decision allowed MPROC to earn a return on assets of 152 percent in 2005 and 218 percent in 2006, which was three to four times greater than that earned by Medtronic as a whole (55 percent). 152 In considering this disparity, keep in mind that MPROC owned no significant intangible assets. As argued later, my view is that a CUT analysis that results in such a large disparity in profitability (or profit potential) cannot be considered reliable. 153

Turning to the CUT analysis itself, there are several shortcomings. Many were identified by the IRS in its appellant brief to the Eighth Circuit, and some of them were addressed by the Eighth Circuit itself. The following paragraphs discuss some of the most important ones.

a. Magnitude of adjustments.

The regulations specify that the number, magnitude, and reliability of adjustments made in the application of a transfer pricing method greatly influence the determination of whether it is the best method. 154 In this case, the reliability of the adjustments is called into question by the lack of explanation for their derivation. 155 The magnitude of the adjustments is also problematic: Taken together, for the devices license, the adjustments increased the royalty from 7 percent to 30 percent, more than a 400 percent increase. 156

147 Id. at *135.
148 Id. at *136.
149 Id. at *136-*137.
150 Id. at *137.
151 Id. at *138.
152 See supra notes 8-9 and accompanying text.
153 More accurately, my view is that a CUT analysis that results in such a large disparity in ex ante expected profits cannot be considered reliable. Although such a disparity could result from differences between ex ante and ex post profits resulting from how risks play out, it does not appear that MPROC’s results could be justified on this basis given, among other reasons, that there were higher costs than expected in 2005 because of the recall of the Marquis devices. See Brief for the Appellee, supra note 89, at 25.
154 Reg. section 1.482-1(c)(2)(i).
155 In this regard, the derivation of the adjustments for exclusivity and access to improvements were not described at all. Most of the other adjustments were justified by reference to the magnitude of these two adjustments. See supra text accompanying notes 144-149.
156 See Brief for the Appellant, supra note 8, at 50-51.
**b. Litigation settlement.**

To be comparable, the regulations require the transactions to take place under comparable circumstances and in the ordinary course of business.\(^{157}\) The Pacesetter agreement arguably fails both criteria because it was entered into in settlement of litigation involving employment and antitrust issues as well as patent issues.\(^{158}\)

**c. Cross-license.**

The regulations also require consideration of any “collateral transactions.”\(^{159}\) The cross-license of Pacesetter patents is a collateral transaction that calls into question its comparability. At a minimum, an upward adjustment would be required to account for the implicit royalty rate on the cross-license.\(^{160}\)

**d. Upfront fee.**

The regulations require adjustments for significant differences in contractual terms.\(^{161}\) The Pacesetter agreement included a substantial upfront fee ($75 million) whereas the intercompany license did not.\(^{162}\) Although an upward adjustment to the royalty rate would be appropriate, none was made.

**e. Different intangibles.**

The Pacesetter agreement included a narrower range of intangibles than the intercompany licenses. Although the Tax Court made adjustments for some product differences, the adjustments were not supported by analysis, and there were other differences that were not accounted for.\(^{163}\)

**f. Different profit potential.**

The regulations governing intangible property transactions require that transactions have “similar profit potential” to be considered comparable.\(^{164}\) This requirement reflects Treasury’s response to section 482’s requirement that income from intangibles be “commensurate with income” attributable to the intangibles.\(^{165}\) The Tax Court made an adjustment of 3.5 percentage points for differences in profit potential but undertook no supporting analysis. According to the IRS’s analysis, Medtronic’s combined operating margin was 52.6 percent whereas Pacesetter’s pre-royalty margin was only 17.7 percent.\(^{166}\) Such a large difference in profitability suggests that the agreements cannot be considered comparable in the first place. However, if an adjustment is to be made, 3.5 percentage points would seem to be inadequate.

In its appellant brief, the IRS pointed out another anomaly in the Tax Court’s approach to profit potential: While the court made only a 3.5 percentage point adjustment to the Pacesetter royalty rate to derive the devices license royalty rate, it made a much larger adjustment to the devices license royalty rate to derive the leads license royalty rate (adjusting the royalty down from 30 percent to 15 percent) without explanation for the difference in approach.\(^{167}\)

In conclusion, my central concern with the Tax Court’s CUT analysis is that it relied on so many adjustments that it was unmoored from both prices and profits. That is, it is difficult to consider a 7 percent royalty to be a valid price benchmark if adjustments increasing the rate to 30 percent are necessary. Any adjustment to a price benchmark to account for very large differences in profit would be highly speculative and unreliable. If it is impossible to benchmark a royalty to a truly comparable transaction, I believe a profit-based method (such as CPM or RPSM) must be used.

**F. Eighth Circuit: Remand**

The Eighth Circuit took the IRS’s criticisms of the Tax Court’s CUT analysis to heart. The court of appeals emphasized four of the shortcomings of the Pacesetter agreement laid out earlier: that it was a litigation settlement, that it involved a cross-


\(^{158}\) See Brief for the Appellant, supra note 8, at 37-39.

\(^{159}\) Reg. section 1.482-4(c)(2)(iii)(B)(2)(vii).

\(^{160}\) See Brief for the Appellant, supra note 8, at 41-43.


\(^{162}\) See Brief for the Appellant, supra note 8, at 39-40.

\(^{163}\) See id. at 44-47.

\(^{164}\) Reg. section 1.482(c)(2)(iii)(B)(ii).

\(^{165}\) Section 482 (second sentence).

\(^{166}\) Brief for the Appellant, supra note 8, at 49-50.

\(^{167}\) Id. at 72-74. According to the IRS’s analysis, although devices generated more revenue than leads, profit margins on leads were actually slightly higher than on devices. Id. This calls into question whether different royalty rates for devices and leads were appropriate.
license, that it had a $75 million upfront fee, and that it covered different intangible property. The Eighth Circuit concluded that the Tax Court’s factual findings were insufficient to allow it to fully evaluate whether the CUT analysis was appropriate. It overturned the Tax Court’s decision and remanded the case, instructing the Tax Court to better substantiate its findings and analysis.

The Eighth Circuit also instructed the Tax Court to make appropriate findings about the level of risk borne by MPROC:

Finally, the tax court did not decide the amount of risk and product liability expense that should be allocated between Medtronic US and [MPROC]. The [IRS] contends that [MPROC] bore only 11 percent of the devices and leads manufacturing costs, which included its share of the product liability expense, and that therefore [MPROC’s] allocation of profits should be a similar percentage based on its economic contribution. The tax court rejected the [IRS’s] 11 percent valuation, concluding that it was unreasonably low because it did not give enough weight to the risks that Medtronic Puerto Rico incurred in its effort to ensure quality product manufacturing. Accordingly, the tax court allocated almost 50 percent of the device profits to [MPROC]. In doing so, the tax court also rejected the [IRS’s] comparable profits methods because it found that the comparable companies used by the [IRS] under this method did not incur the same amount of risk incurred by [MPROC]. Yet the tax court reached these conclusions without making a specific finding as to what amount of risk and product liability expense was properly attributable to [MPROC]. In the absence of such a finding, we lack sufficient information to determine whether the tax court’s profit allocation was appropriate.

IV. Alternative Approaches

A. CUT Method

The Tax Court certainly has the option to defend its CUT method decision without modifying the analysis itself. All that the Eighth Circuit requested was for the Tax Court to provide additional factual findings to support its decision. Three of the Eighth Circuit’s requests were additional findings about the comparability of the Pacesetter agreement — specifically, findings about the circumstances of the agreement, its contractual terms, and the remaining intangibles (intangibles that were included in the intercompany license but not the Pacesetter agreement). These are fairly straightforward requests that the Tax Court would likely be prepared to address with minimal additional proceedings. Having said this, one of the Eighth Circuit judges confessed that he “harbor[s] serious doubts” that he will be persuaded that the agreements are comparable.

The Tax Court may take this admonition to heart and abandon the CUT method for one of the other methods suggested here. But first let’s assume the court decides to continue using the CUT method.

The final factual finding that the Eighth Circuit requested was identified earlier: “a specific finding as to what amount of risk and product liability expense was properly attributable” to MPROC. This undoubtedly poses a much more difficult challenge for the Tax Court than the other factual findings and is likely to be the centerpiece of further proceedings once they are rescheduled. The Eighth Circuit did not frame this request in terms of whether the Pacesetter arrangement was comparable to the intercompany license, but rather in terms of whether the “profit allocation was appropriate.” So the Eighth Circuit is drawing a direct connection between risk and profit. In a CUT

\begin{footnotes}
\item[168] 900 F.3d at 614-615.
\item[169] Id. at 615.
\item[170] Id.
\item[171] Id. at 614-615.
\item[172] Id. at 618 (Shepherd, J., concurring).
\item[173] Id. at 615.
\item[174] Id.
\end{footnotes}
method analysis, such a connection would implicate the requirement that the licenses have comparable profit potential.\textsuperscript{175}

Recall that the Tax Court made an adjustment for profit potential by adding 3.5 percentage points to the royalty rate for the devices license, which I consider inadequate given the large difference in profit margins between Medtronic and Pacesetter.\textsuperscript{176} Unfortunately, the regulations are not helpful regarding profit potential, so it is understandable that the Tax Court’s analysis failed to fully account for differences. The regulations state:

> The profit potential of an intangible is most reliably measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible.\textsuperscript{177}

The problem with this regulation is that it requires a more difficult and uncertain analysis than is often appropriate. Generally, the operating profit margin generated by the use of an intangible is more important than the absolute amount of profits generated. It is usually much easier to make a reasonable estimate of the expected profit margin than the total amount of profits that might be generated over the economic life of the intangible.

There are many ways an economic expert might go about making a more accurate adjustment for differences in profit potential. I will offer one simple observation here. Consider this comparison:

- the 7 percent royalty in the Pacesetter agreement would leave MPROC with an operating margin of only 10.7 percent (given a pre-royalty margin of 17.7 percent);\textsuperscript{178} while
- total royalties of 38 percent for devices and 23 percent for leads leave MPROC with an operating margin in excess of 30 percent.\textsuperscript{179}

If the royalty rates were adjusted to leave MPROC with an operating margin similar to Pacesetter’s, they would have to be increased by approximately 19 percentage points.

B. CPM (Ex Post)

In theory, the Tax Court could abandon its CUT method approach and adopt a traditional CPM approach instead. In its Medtronic opinion, the Tax Court rejected the IRS’s CPM approach in particularly scathing terms, so it seems unlikely the court will adopt a traditional CPM approach — even with modifications. But let’s consider what modifications the court could consider.

By “traditional” CPM approach, I refer to an approach that is undertaken at the end of each year. That is, it is based on actual profits (ex post profits) rather than profits that were expected when the licenses were initially entered into (ex ante profits).\textsuperscript{180} Comparable companies are identified each year, and a range of arm’s-length operating profits are calculated. If MPROC’s actual results fall within this range, there would be no adjustment to the royalty in that year. If the results are outside this range, an adjustment to the royalty would be made that brings that year’s results to the median of the range.\textsuperscript{181} Adopting a CPM approach requires a willingness to accept that the effective royalty rate (as a percentage of sales) may differ from year to year depending on whether an adjustment is required.

Assuming the Tax Court accepts the notion of a variable royalty rate, the most likely modification

\textsuperscript{175}Total royalties are the sum of the 8 percent trademark royalty and the applicable technology royalty on intercompany sales as determined by the Tax Court. Operating margins are based on operating profit of $598 million in 2005 and $925 million in 2006 (see supra note 8) and revenue of $1.98 billion in 2005 and $2.882 billion in 2006. See Agreed Computation for Entry of Decision, T.C. Memo. 2016-112 (Jan. 12, 2017) (No. 006944-11), at page 3 of the detailed calculations.

\textsuperscript{176}In fact, strictly speaking, CPM must be applied on an ex post basis. See reg. section 1.482-5(b)(1) (“tested party’s reported operating profit is compared to the comparable operating profits”) (Emphasis added.). The method described in the following section would actually be an unspecified method.

\textsuperscript{177}This explanation is slightly oversimplified. In fact, CPM ordinarily must be applied using average results over a multiple-year period for both the tested party and the comparable companies. Reg. section 1.482-1(f)(2)(iii)(B). See also reg. section 1.482-5(e) (examples of CPM using three-year average results).
to the IRS’s approach that it would make would be to identify comparable companies that it considers to bear risks that are more closely comparable to the risks borne by MPROC. Arguably, different companies should be selected each year depending on how risks actually played out during the year for MPROC. That is, if MPROC experienced the negative effects of a risk playing out, only companies that also experienced negative effects would be included in the comparable set. Conversely, if MPROC had good luck or managed risks particularly well during the year, only companies that also encountered good luck or successful risk-taking would be included in the set.

In any event, because most of the comparable companies selected by the IRS already bore all the risks faced by companies in the medical device industry, it is not clear how the Tax Court would find a set of comparable companies that supports a much higher profitability level than the IRS’s comparables. One of the key reasons that the court rejected the IRS’s comparables was that they not only bore all the risks faced by companies in the industry but also performed all the functions that Medtronic as a whole performed. The Tax Court would likely find it difficult to identify comparable companies that bear a high level of risk but perform only the limited manufacturing functions undertaken by MPROC.

An alternative approach would be to identify companies that have comparable functions and assets but do not bear significant risks, and to then make adjustments to the comparable companies’ operating profits that properly account for MPROC’s risk profile. Most likely, this would involve determining an upward adjustment to the selected profit-level indicator (a risk premium). It is beyond the scope of this report to propose a precise approach, but it could involve using standard finance and economic principles and tools (such as the capital asset pricing model). Having said this, it would arguably be more appropriate to make a downward adjustment if risks actually played out in a negative way during the year, and to make an upward adjustment if MPROC had good luck or managed risks well.

C. CPM (Ex Ante)

A variation of the traditional CPM approach might be more acceptable to the Tax Court. Rather than comparing the tested party’s ex post operating profits against comparable companies’ profit levels, the profits that the tested party is expected to earn ex ante would be benchmarked against comparable company profit levels. In stark contrast to the traditional CPM approach, the CPM analysis would be undertaken only one time. The arm’s-length royalty rate would be determined at the time the intercompany license is initially entered into, and it would not be adjusted in future years.

An ex ante CPM approach would account for risk in two different ways, consistent with solid economic principles. First, a target operating margin would be determined that reflects the operating profits that the tested party would be expected to earn if actual results play out as expected. Either of the two approaches described above for the traditional CPM approach could be applied to determine the target operating margin:

- benchmark the margin based on profit margins earned by companies that bear a comparable level of risk as MPROC (as well as having comparable functions and assets); or
- benchmark the margin based on profit margins earned by companies that do not bear a significant level of risk (but do have comparable functions and assets) and then adjust this margin upward by an appropriate risk premium.

Second, because there would be no ex-post adjustment to the royalty rate, actual profits would reflect the playing out of risk. If risks play out badly, the tested party will not achieve the target operating margin and may even suffer losses. If risks are well managed, the tested party’s actual results will exceed the target margin.

The most difficult step in applying an ex ante CPM approach is the development of profit projections at the time the license is entered into. To quote an unrelated section of the regulations, these should be “best estimates . . . normally reflecting a probability weighted average of possible
outcomes.” When a taxpayer is trying to minimize the size of the royalty, there would be an incentive to understate the licensee’s expected profitability. Tax authorities would have the opposite incentive. Although tax authorities conducting an audit would have the benefit of hindsight in assessing what profits should have been expected, the determination should be based solely on information available at the time the license was entered into. If the Tax Court decides to use an ex ante CPM approach in resolving the case, a key challenge will be to make this determination.

To illustrate how this method would work, consider this highly stylized example. First, assume the following probability-weighted estimate of MPROC’s sales and expenses apply to each and every year that the license is in effect, as noted in Table 2:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product liability expense</td>
<td>$100</td>
</tr>
<tr>
<td>Other costs and expenses</td>
<td>$200</td>
</tr>
<tr>
<td>Pre-royalty operating profit</td>
<td>$700</td>
</tr>
</tbody>
</table>

Second, assume that the risk-adjusted target operating margin is determined to be 15 percent. The arm’s-length royalty rate would be 55 percent of sales — that is, the difference between the pre-royalty margin (70 percent) and the target margin (15 percent).

Consider actual product liability expense to be the main indicator of how risks play out. If risks play out exactly as expected, MPROC will earn an after-royalty operating profit of $150 (15 percent). However, if unexpected product liability risks materialize and actual expense is $200 (rather than $100), MPROC’s actual operating margin will only be $50 (5 percent). On the other hand, if MPROC successfully manages its product liability risks and actual expense is only $50, its actual operating margin will be $200 (20 percent).

D. Profit-Split Method

Although an ex ante CPM approach has a strong foundation in economic theory, it is not a method that is explicitly specified in the regulations. For this and other reasons, the Tax Court may be unwilling to consider it. The remaining method that is specified for intangible property transactions is the profit-split method. There are several reasons to think the Tax Court would give this method serious consideration. One is the fact that the Eighth Circuit specifically framed the request for additional findings on risk in terms of whether the “profit allocation was appropriate.” Another is the fact that the IRS and Medtronic had previously agreed to a profit-split method as part of their prior-year settlement agreement. Although the Tax Court did not perform a profit-split method analysis, it allowed the results of the parties’ prior-year agreement to stand with minimal change.

The problem with trying to use the profit-split method for Medtronic is that there is no guidance on how the bearing of risk should affect the sharing of profit. I am not convinced that there is a wholly satisfactory way to do so. However, I do believe that a profit-split approach would be an improvement over a CUT approach, so it is worthwhile to give some thought to the question. Recall that the method specified in the U.S. regulations is actually the RPSM — the residual profit-split method. Under the RPSM, the profit to be split is the profit remaining after each party is allowed a profit for its routine contributions. Because the lion’s share of the profits in Medtronic would be residual profits, I will not dwell on the routine profit step.

The regulations provide that residual profits should be split in proportion to the value of each party’s nonroutine contributions to the business activity. Contributions of intangible property

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183 Reg. section 1.482-7(g)(2)(v) (regarding the income method under the cost-sharing regulations).
184 See supra quotation accompanying note 170.
185 See supra text accompanying note 77.
186 That is, the Tax Court found that Medtronic underpaid its U.S. income taxes by less than $15 million in the 2005-2006 period. See supra note 3 and accompanying text.
187 I would note, however, that Medtronic US’s routine profits should be significantly greater than MPROC’s because it incurs more costs and owns more assets.
188 Reg. section 1.482-6(c)(3)(ii)(A).
are the only type of nonroutine contribution for which the regulations provide guidance. If RPSM were to be applied in Medtronic, bearing of risk would also be considered a nonroutine contribution. The Tax Court presumably will make a finding regarding the relative share of risk that is borne by each party. Conceptually, the difficult question is how to weigh the relative values of intangible property ownership versus bearing of risk. That difficulty is compounded by the fact that, unlike intangible property, the effect of risk on profit would vary from year to year depending on the extent to which deleterious risks materialize. The most likely resolution of these difficulties by the Tax Court may well be quite simple: As a matter of rough justice, the court might assume that the value of the contribution of intangibles and the value of contributions of risk are equal.

Consider a simple example of the calculation. Although I have argued that only Medtronic US contributed valuable intangible property, let’s assume the Tax Court disagrees and finds that Medtronic US contributed 90 percent of the intangible property. Further, let’s assume that the court finds that MPROC bears a substantial share of risk — say, 40 percent. Medtronic US’s share of residual profit would then be: (90 percent * 50 percent) + (60 percent * 50 percent) = 75 percent.

V. Conclusion

This report has explored the ongoing Medtronic litigation in considerable detail. The case is particularly interesting because one of the related parties bears substantial risks even though it does not own valuable intangible property. The Eighth Circuit has asked the Tax Court to make findings about the magnitude of this risk, but it has not provided any guidance on how risk bearing should affect arm’s-length transfer pricing. This report offers four possible approaches that the Tax Court could consider. Two of them are refinements of methods previously used by the Tax Court (the CUT method) and by the IRS (traditional CPM). It is doubtful that either of these approaches will prove satisfactory. Two additional methods that may be more promising have been introduced and described: an ex ante CPM approach and a profit-split approach.

189 Reg. section 1.482-6(c)(3)(i)(B)(2).
190 This risk share would not only account for product liability risks but also for all the other business risks, such as development risks and patent infringement risks.