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*This thought leadership paper dwells on a US transfer pricing case.*

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This thought leadership paper covers the key aspects of the decision in the case of Medtronic, Inc v. Commissioner, adjudicated by the IRS, which covers incorrect classification of an entity as a mere assembler of components, when in reality it was performing highly skilled labor which affected the final product. The decision also covers the adjusted royalty rates that the IRS upheld for the access to intangibles required for the production of the final product.

**The case:**
Medtronic, Inc v. Commissioner: *(Judge strikes down $2 billion adjustment, says IRS wrongly treated Puerto Rico affiliate as a mere assembler of components. Additionally, the court adjusted the royalty rates Medtronic proposed for licensing agreements).*

**Facts:**
The taxpayer *(Medtronic, Inc)* is a large US based corporation with various worldwide subsidiaries and branches that was involved with manufacturing and selling medical device pulse generators *('devices')* and physical therapy delivery devices *('leads')* during the years at issue.

The taxpayer entered four separate inter-company agreements with Medtronic Puerto Rico Operations Co. *('MPROC')*, a subsidiary that completed manufacturing and sales functions in Puerto Rico. The four agreements governed:

1) the sale of components;
2) the distribution of devices and leads manufactured by MPROC and sold by Med USA *(another one of Medtronic, Inc.'s subsidiaries)*;
3) the ability of MPROC to use trade marks and names owned by the taxpayer; &
4) the licensing of intangible property used by MPROC in manufacturing devices and leads.

The agreements reflected MPROC's manufacture and sales of devices and leads to Med USA, and the royalty rates that MPROC paid Medtronic, Inc in exchange for access to intangibles required for those devices and leads. The agreements applied royalty rates that were calculated using the comparable uncontrolled transactions *('CUT')* method. The royalty rates were 29% on net inter-company sales of devices, and 15% on net inter-company sales of leads. The use of this method was based on an agreement Medtronic, Inc made with an unrelated company, Siemens Pacesetter *('Pacesetter'),* which involved intangibles similar to the ones for the devices and leads in this case.

The IRS issued a notice of deficiency, with deficiencies of $198 million for 2005, and $759 million for 2006. The adjustments were based on the position that the comparable profits method *('CPM')* was the best method to determine the arm's-length royalty rate, and that MPROC did not have economically significant functions except that of assembling a finished product.

**Holding:**

The Tax Court held that the taxpayer met its burden in showing that the IRS's allocations were arbitrary, capricious, or unreasonable, and struck down the IRS's adjustments for 2005-2006. The Tax Court also held that the taxpayer had not met its burden and the royalty rates the taxpayer proposed were not arm's-length except the trademark license agreement allocations. Therefore, the Tax Court was required to determine the proper method, and applied the CUT method with adjustments.

The Tax Court found that, contrary to the analysis of the IRS's expert, MPROC did more than just assemble components into a final product. The Tax Court concluded that MPROC's highly skilled workforce played a significant role in quality control of the final manufacture of the devices in a highly regulated environment of an FDA registered site and therefore the IRS's proposed royalty rate did not give appropriate weightage to MPROC's role, however the adjustments to the Pacesetter CUT royalty allocations were wholly unpersuasive.

The Tax Court, citing Reg. §1.482-4*(a)*, stated that the CUT method was a proper method to determine taxable income in connection with a transfer of intangible property and stated the regulations provide guidance on proper adjustments that can be made to account for differences between controlled and uncontrolled transactions. The Tax Court noted specifically that MPROC had access to the taxpayer's know-how in making the products and the fact that the product had more profit potential due to its quality. The Tax Court explained that it calculated a revised royalty rate of 44% for the devices, and a revised royalty rate of 29% for the leads.

The Tax Court then reasoned that the 44% rate should also apply to the royalties paid from Europe *(Medtronic Inc.'s first-tier Swiss subsidiary)* to the taxpayer because it agreed to pay the taxpayer an amount equal to the royalties that MPROC would have paid if it had manufactured the devices and sold them to Medtronic, Inc.

Finally, the Tax Court also rejected the IRS's alternative argument that if the Court did not agree with its allocations under the notice of deficiency, that the intangible property was transferred to MPROC when it was formed in 2002. The Tax Court concluded that the transfers were not subject to §367*(d)* because the IRS's witness stated that no §936*(h)(3)(B)* intangibles were transferred.

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