‘Medtronic’ Ruling Bolsters Multinational Corporate Tax Options
Aug. 24, 2022, 4:46 AM
Bloomberg Tax
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• Tax Court embraced uncommon method for multinational taxes
• Potential appeal looms over question of decision’s impact

A US Tax Court ruling that resembled a Dr. Frankenstein creation in a $1.4 billion fight over medical device manufacturer Medtronic’s taxes pushed the door open wider for using unspecified methods to calculate multinational tax bills.

An “unspecified method” is one of four eligible methods under IRS regulations for determining the tax bills that arise when intangible property is transferred across borders between entities that are part of the same multinational company.

Judge Kathleen Kerrigan’s Aug. 18 opinion stitched together different methods and adjustments to create what could be a “new creature that’s walking the earth of transfer pricing,” according to Blaine Saito, a Northeastern University law professor who focuses on tax issues.

“If there is no appeal, I think it opens the door to seeing that,” Saito said.

Multiple Methods

The four methods for these types of tax bills include one initially proposed by Medtronic, the comparable uncontrolled transaction method. The CUT method generates a tax bill through comparison to a transaction between entities that were not related.

Another method is the IRS-proposed comparable profits method. The CPM method looks at profitability measures derived from comparable exchanges between unrelated entities.

“Transfer pricing” refers to the area of tax policy dealing with cross-border asset shifts. Any transfer pricing method may only be used if it offers the most reliable measure of the taxes that would arise if the asset-shifting parties weren’t part of the same multinational company or otherwise related.

Unspecified methods are “probably the least used by taxpayers and the IRS” because “there has always been the perception that you should stick to the methods specified in the regulations,” according to Mark Horowitz, a principal in KPMG’s Washington National Tax practice who focuses on corporate international tax issues.

Kerrigan’s unspecified method drew from the CUT and CPM approaches, and made further adjustments that bridged the gap between the two parties.

The Ruling
The ruling will hike up Medtronic’s taxes for 2005 and 2006 above the roughly $14 million the court ruled the company owed in 2016. That ruling was tossed out by the US Court of Appeals for the Eighth Circuit in 2018, which ordered the Tax Court to make further factual determinations.

Kerrigan’s new opinion increased a royalty rate that is tied to the US tax bill to 48.8%, from 38% in her 2016 ruling. The parties will calculate what the change means for the precise tax bill—which the IRS had argued should be nearly $1.4 billion—in further proceedings.

“In cases that are in litigation or in IRS Appeals, both sides will have to consider the impact of Medtronic and the use of an unspecified method in Medtronic,” Horowitz said. “I think it will open up the playing field a bit more to both sides to deviate from the specified methods more than they historically have,” he said.

An Appeal?

The question of an appeal still looms over not only Medtronic’s tax bill but also the impact of the Tax Court’s unspecified method on other cases. The Eighth Circuit said in 2018 it needed more findings to help the circuit review whether the Tax Court applied the best transfer pricing method and made proper adjustments.

While Kerrigan’s 2016 ruling had made adjustments to Medtronic’s proposed CUT method, her new ruling made adjustments to an unspecified method Medtronic proposed after Kerrigan indicated at trial she was considering the unspecified route for her second decision.

Horowitz thought Kerrigan had probably done enough to address the Eighth Circuit’s specific concerns, but he zeroed in on a particular adjustment she made—shifting the allocation of certain profits so 80% went to Medtronic’s US operations and 20% went to Puerto Rican operations—as an area where the circuit could think she used a “blunt instrument” to get to her result.

Kerrigan wrote that her overall solution in the case “may not be perfect,” but it wasn’t an attempt to simply create a hybrid between the CUT method and the CPM, and that if the IRS “had provided a way to make further modifications to the CPM,” she would have considered it.

If there is an appeal, the Eighth Circuit also could quibble over whether Kerrigan spent enough time discussing why the CPM wasn’t the best method compared to her discussion of adjustments and why the CUT method wasn’t appropriate, Horowitz said.

Future Method Choices

The Medtronic case demonstrates the importance of businesses telling their stories in ways that show how their transfer pricing methods and results reflect their economic realities, according
to Barbara Mantegani, a lawyer at Mantegani Tax PLLC who specializes in transfer pricing.

“Personally, I think we are at the point where there might need to be more consideration of unspecified methods, so long as the underlying results make sense from a business perspective,” Mantegani said in an email.

“When a company’s business model does not fit into any of the round holes that underlie all the specified methods, rather than trying to jam the square peg into one of those holes, it is necessary to tell the company’s story based on its actual business model, and explain the reasons for the distribution of profit based on that actual business model,” she said.

There is a risk, however, that the court’s decision will create too much uncertainty about how to calculate multinational tax bills, according to Harvey Poniachek, a professor of practice in Rutgers Business School’s finance and economics department.

“An unspecified method is chaos,” he said. “Every expert is going to come up with a different methodology—so the sky is the limit.”

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