ALSTON & BIRD

WWW.ALSTON.COM

International Tax ADVISORY ■

SEPTEMBER 16, 2022

School Was Out for the Summer, but the Courts Were in Session: What Do *Eaton* and *Medtronic II* Mean for Taxpayers?

The judicial branch was busy over the summer churning out transfer pricing cases, with the Sixth Circuit Court of Appeals' decision in *Eaton Corp. and Subsidiaries v. Commissioner* involving the IRS's ability to cancel an advance pricing agreement (APA) and the Tax Court's decision in *Medtronic Inc. v. Commissioner* concerning whether the comparable uncontrolled transaction (CUT) or another method is the best method for testing the licensing agreements between Medtronic US and Medtronic Puerto Rico.

Can the IRS Cancel My APA? It Depends, but Is Unlikely

In *Eaton*, the Sixth Circuit addressed the IRS's cancellation of two APAs covering the Eaton's 2001–2010 tax years and dealt the IRS another loss in a transfer pricing case. A few years after executing the APAs and submitting annual reports to the IRS, Eaton identified certain errors in its annual reports and informed the IRS. Although Eaton corrected its mistakes, the IRS believed the mistakes were grounds for it to unilaterally terminate the APAs for 2005–2006. The IRS canceled the APAs, issued a notice of deficiency, and asserted penalties. Eaton petitioned the Tax Court and challenged the IRS's notice of deficiency and cancellation of the APAs. The Tax Court held that the IRS was wrong in canceling the APAs, but it sided with the IRS on the applicable standard of review: whether the IRS abused its discretion in canceling the APAs. The IRS appealed the Tax Court's holdings on APA cancellation and the assertion of penalties, and Eaton cross-appealed to reassert its claim to apply Revenue Procedure 99-32. The Sixth Circuit found in favor of Eaton on all three issues.

The Sixth Circuit does not mince words—the IRS must abide by contract-law principles

On August 25, 2022, the Sixth Circuit issued its opinion. On the threshold question of who bears the burden of proof, the Sixth Circuit addressed de novo the Tax Court's opinion:

> Who has the burden? Both APAs incorporated the Revenue Procedures, which say that the IRS "may cancel" the agreement for various enumerated grounds, including, among other things, "mistake as to a material fact" or the "failure to state a material fact." … Must the IRS prove these grounds consistent with contract-law principles, or is it Eaton's burden to show that the cancellation was "plainly arbitrary"?

Rejecting the IRS's arguments, the Sixth Circuit made clear that contract-law principles apply, and therefore, the IRS bears the burden of proof:

> The IRS has the burden. In arguing to the contrary, the IRS hides behind administrative deference to avoid the consequences of its bargain. In its view, after the parties spent years negotiating a bargain of this complexity, the government can simply rip up the contract unless the taxpayer can show that doing so is "plainly arbitrary." … [Canceling] a contract is just like any other agency determination—forget about what contract law demands, says the IRS. We disagree. Neither the available cases nor the IRS's own regulations and procedures support the IRS's argument.

The Sixth Circuit found that the case law clearly establishes that when the United States enters into contract relations, the law that applies to contracts between private individuals generally governs its rights and duties. Because contract law applies, the IRS has the burden to prove that the exception it claims allows it to cancel the contract—a higher bar than an abuse of discretion standard.

Further restricting the IRS's grounds for canceling an APA, the court also concluded that the IRS could not cancel the APA for reasons other than those stated in the cancellation subsection of the revenue procedure governing APAs. The subsection allows cancellation for the failure of a critical assumption, the taxpayer's misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good-faith compliance with the terms and conditions of the APA. The revenue procedure governing APAs states that material facts are those that, if known by the IRS, would have resulted in a significantly different APA or no APA at all. The Sixth Circuit held that after-the-fact miscalculations cannot thus be "material" pursuant to the IRS's definition of materiality.

Why is the Sixth Circuit's decision important?

The Sixth Circuit's decision is a win for taxpayers that have APAs or are considering obtaining APAs because it clarifies the application of contract-law principles to APAs and the burden of proof to the extent a party desires to cancel an APA. Although the cancellation or revocation of an APA is an extremely rare situation—only 11 APAs have been canceled or revoked since the beginning of the APA program in 1991—the Sixth Circuit's decision further confirms that the IRS bears the burden of proof if it decides to cancel an APA.

How to Identify an "Unspecified" Method: *Medtronic II*

What transfer pricing method did the Tax Court apply in *Medtronic II*? Is it an unspecified method, an inexact CUT method, a profit split method, or something else entirely? At what point does an inexact CUT method with comparability adjustments become an unspecified method? On August 18, 2022, the Tax Court delivered its opinion in *Medtronic II*, raising many questions.

Back to the drawing board for the Tax Court

In 2018, the Eighth Circuit Court of Appeals vacated the Tax Court's 2016 opinion in *Medtronic I* and remanded the case on the basis that the Tax Court failed to provide sufficient analysis on whether the purported CUT and the licensing agreements between Medtronic US and Medtronic Puerto Rico (MPROC) were sufficiently comparable. The Tax Court scheduled expert testimony mainly on (1) whether the Pacesetter agreement (i.e., the licensing agreement that Medtronic US entered into with Pacesetter) could be used as a CUT (including appropriate adjustments, comparability factors, etc.); and (2) an analysis comparing the taxpayer's CUT method with the IRS's comparable profits method (CPM), including which is the best method.

In *Medtronic II*, the Tax Court held that, upon further analysis, the CUT it determined was the best method in *Medtronic I* was no longer the best method. As a result of *Medtronic II*, the Tax Court computed higher royalty rates in favor of the IRS.

In the posttrial phase, Medtronic continued to advocate that the Pacesetter agreement could be used to establish the royalty rate for the IP licensed to MPROC and could be a CUT, as well as proposing two versions of an unspecified method. The IRS did not propose any additional methods other than the CPM, as it did in *Medtronic I*.

In its opinion, the court held that the Pacesetter agreement was not a CUT because it failed to be comparable to Medtronic US's license to MPROC in terms of functions, economic conditions, and property or services. It also held that too many adjustments to the Pacesetter agreement would be necessary and that it would fail, as a CUT, to be the best method. The court evaluated the litigation aspects surrounding the Pacesetter agreement and ultimately concluded that the circumstances between Pacesetter and Medtronic US were "comparable" to the licensing between Medtronic US and MPROC, with a focus on the role of cross-licensing within the cardio device industry.

Even if it is not a CUT, it could still be useful

Although the court determined that the Pacesetter agreement was not a CUT, it held that it could still serve as a "starting point for determining a proper royalty rate." The IRS, however, further argued that using the Pacesetter agreement as a CUT leaves the "lion's share" of profits with MPROC and pointed to the court's holding in *Coca-Cola Co., et al. v. Commissioner* as precedent for applying a CPM to test MPROC's results. The court rejected the IRS's approach, indicating that the assets and activities of MPROC and those at issue in *Coca-Cola Co.* were not comparable, and even with certain modifications to the IRS's CPM (e.g., modifications to the comparables and for product liability), it was not the best method.

The Tax Court's "unspecified" method

Medtronic proposed two versions of its unspecified method, with the first two steps being the same. First, Medtronic applied a modified version of its CUT method and the 8% trademark license to allocate income to Medtronic US's R&D functions. Second, Medtronic allocated income to MPROC based on certain modifications to the IRS's CPM to account for differences in asset intensity between MPROC and the comparables used to apply the CPM. Third, Medtronic allocated the remaining income between Medtronic US and MPROC on either of two optional bases: a 35:65 basis or a 50:50 basis.

The court accepted Medtronic's proposed unspecified method with a modification to the third step. The court increased the allocation of remaining income between Medtronic US and MPROC on an 80:20 basis with a relatively cursory explanation for using that ratio to allocate more than $1.3 billion in income:

> Our adjustment to the third step increases the allocation of remaining profits to Medtronic US. It results in an allocation of 80% to Medtronic US and 20% to MPROC (80–20 allocation). This adjustment is a way of accounting for the imperfections of the CUT method, such as "know-how," having only one comparable, and differences in profit potential, and imperfections of the CPM, such as the inadequacy of the comparables and an unrealistic profit allocation to MPROC. Additionally, the adjustment takes into account petitioner's unsupported increase in asset intensity in step two.

In setting forth its conclusion, the court admonished the IRS on its failure to offer an alternate transfer pricing method:

> Our solution may not be perfect, but it reflects a detailed analysis in the context of the Eighth Circuit's mandate and takes into consideration the level of technology that is needed to make safely the devices and leads. It is not an attempt to create a new method which is simply a hybrid of the CUT method and the CPM. If respondent had provided a way to make further modifications to the CPM, we would have considered that approach.

To a certain extent, it appears that the Tax Court is saying, "We did our best given what we had."

Observations

An appeal of the Tax Court's decision would be made back to the Sixth Circuit. If the case is appealed, it will be interesting to see how the Sixth Circuit views the Tax Court's new unspecified method.

Those who followed the proceedings in *Medtronic II* might not be surprised that the Tax Court pursued an unspecified method to the detriment of the CUT method or CPM. In transfer pricing cases past—before the IRS's victory in *Coca-Cola*—the Tax Court sided with the IRS in applying the CPM in only one other, much lower profile, case: *Wycoff v. Commissioner*. To the extent that the Tax Court's decision in *Medtronic II* is a harbinger of transfer pricing cases future, companies should carefully evaluate their intercompany agreements, the economic substance of underlying transactions, the extent to which specified methods (such as the CUT method or CPM) are being applied reliably under the "best method" rule, and how best to achieve transfer pricing certainty, including the potential utility of an advance pricing agreement.

For more information, please contact Richard Slowinski at 202.239.3231 or Stefanie Kavanagh at 202.239.3914.

You can subscribe to future *International Tax* advisories and other Alston & Bird publications by completing our **publications subscription form**.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

International Tax Group

John F. Baron
Chair
704.444.1434
john.baron@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Andrew B. Claytor
704.444.1081
andrew.claytor@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Laura L. Gavioli
212.210.9432
214.922.3580
laura.gavioli@alston.com

John Harden
404.881.7990
john.harden@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Sam K. Kaywood, Jr.
404.881.7481
sam.kaywood@alston.com

Clay A. Littlefield
704.444.144
clay.littlefield@alston.com

Sarah Ma
202.239.3281
sarah.ma@alston.com

Terence H. McAllister
704.444.1138
terence.mcallister@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Richard L. Slowinski
202.239.3231
richard.slowinski@alston.com

Edward Tanenbaum
212.210.9425
edward.tanenbaum@alston.com

Shawna Tunnell
202.239.3040
shawna.tunnell@alston.com

Ryan Wheeler
704.444.1430
ryan.wheeler@alston.com

Joon Yoo
212.210.9452
joon.yoo@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86.10.85927500
BRUSSELS: Rue Guimard 9 et Rue du Commerce 87 ▪ 3rd Floor ▪ 1000 Brussels ▪ Brussels, 1000, BE ▪ +32.2.550.3700 ▪ Fax: +32.2.550.3719
CHARLOTTE: One South at The Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: Chase Tower ▪ 2200 Ross Avenue ▪ Suite 2300 ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
FORT WORTH: Bank of America Tower ▪ 301 Commerce ▪ Suite 3635 ▪ Fort Worth, Texas, USA, 76102 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LONDON: 4th Floor ▪ Octagon Point, St. Paul's ▪ 5 Cheapside ▪ London, EC2V 6AA, UK ▪ +44.0.20.3823.2225
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ▪ Suite 600 ▪ Raleigh, North Carolina, USA, 27601-3034 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ Suite 430 ▪ East Palo Alto, California, USA 94303 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333