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Eighth Circuit: Tax Court's application of unspecified transfer pricing method rejected

The U.S. Court of Appeals for the Eighth Circuit today rejected the Tax Court's application of an unspecified transfer pricing method to determine royalty income from intercompany licenses for intangible property required to manufacture certain medical devices and leads.

The case is: *Medtronic, Inc. v. Commissioner,* No. 23-3063 (8th Cir. September 3, 2025). Read the Eighth Circuit's **decision**

Summary

The taxpayer is a U.S. medical device company, with a device manufacturing subsidiary located in Puerto Rico. The taxpayer allocated the profits earned from its devices and "leads" through its intercompany licensing agreements. The taxpayer's income tax return for 2002 used the comparable uncontrolled transactions (CUT) transfer pricing method to determine the royalties paid on its intercompany licenses.

The IRS, on audit, determined that the taxpayer was shifting too much profit to Puerto Rico in an attempt to avoid taxation in the United States. The IRS applied a modified comparable profits method (CPM) to conclude that 90% of the profit was to be allocated to the U.S. operations and 10% to the Puerto Rico operations. To resolve the audit, the taxpayer and IRS entered into a "memorandum of understanding" by which the Puerto Rico subsidiary agreed to pay royalty rates of 44% for devices and 26% for leads on its intercompany sales. The IRS in return agreed to apply these rates in future years (if there were no changes). Neither party considered these rates to be at an arm's length price, but only as a compromise to resolve the audit.

The IRS and the taxpayer could not agree on how the memorandum applied to the royalty income for 2005 and 2006 tax years. After completing its audit, the IRS proposed to increase the royalty payments by $455 million—ultimately resulting in tax deficiencies of $548 million for 2005 and $810 million for 2006. The taxpayer initiated an action in the Tax Court which, in June 2016, rejected both the taxpayer and IRS positions and "engaged in its own valuation analysis" to find that the CUT method was to be used to determine the arm's length royalty rate for the intercompany agreements—but with a number of adjustments. The Tax Court found the arm's length royalty rate for the device licenses was 44% and the rate for lead licenses was 22%. This resulted in an order that the taxpayer had an income tax deficiency of $26.7 million in 2005 and a tax overpayment of $12.4 million in 2006.

The Eighth Circuit, in August 2018, vacated the Tax Court's determination in *Medtronic, Inc. v. Commissioner* (*Medtronic II*), 900 F.3d 610 (8th Cir. 2018). The Eighth Circuit found that the Tax Court's determination that an agreement between the taxpayer and a third party was an appropriate CUT was not sufficiently supported by factual findings, and remanded to the Tax Court for further consideration and factual findings necessary to the determination of whether it applied the best transfer pricing method for calculating an arm's length result or whether it made proper adjustments under its chosen method.

On remand, the Tax Court concluded that the taxpayer did not meet its burden to show that its allocation under the CUT method and its proposed unspecified method satisfy the arm's length standard. The Tax Court further concluded that the IRS's modified CPM was not the best method for determining an arm's length royalty rate. Having rejected the preferred methods of both parties, the tax court applied a three-step unspecified method as proposed by the taxpayer, but with some adjustments. Step one applied a modified version of the taxpayer's CUT method as a "starting point" to price the taxpayer's research and development (R&D) activities; step two applied a modified version of the IRS's CPM to allocate profit to the Puerto Rican subsidiary's finished-device manufacturing functions; and step three split the remaining profit from the devices and leads between the taxpayer and its subsidiary. The Tax Court determined a wholesale royalty rate of 48.8% for both leads and devices, which resulted in an overall profit split of 68.7% to the taxpayer and 31.3% to its subsidiary.

Both parties appealed the Tax Court's decision, and the Eighth Circuit today vacated the Tax Court's decision. The Eighth Circuit rejected the Tax Court's use of an unspecified method and found that the Tax Court applied an incorrect standard in rejecting the CPM. The Eighth Circuit thus remanded to the Tax Court to apply the correct legal standard to consider application of the CPM, and assuming application of the CPM is appropriate, make various necessary factual determinations in connection with application of the CPM.

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