CURRENT TAX COURT LITIGATION ILLUSTRATES INTANGIBLE PROPERTY TRANSFER PRICING AND VALUATION ISSUES

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MOVING INTANGIBLE PPROPERTY ASSETS OVERSEAS PRESENTS BOTH BUSINESS AND TAX ISSUES

The movement of intangible property ("I.P.") offshore by U.S. multinational corporations has always been subject to high levels of I.R.S. scrutiny. This remains true in the current tax environment. It is a given that U.S. multinational companies are subject to a high level of U.S. corporate income tax at federal and state levels and their non-U.S. business operations are typically subject to lower tax rates abroad. As a result, U.S. multinationals can lower their global tax expense by transferring I.P. to an offshore subsidiary company ("I.P. Company"), when it is appropriate and consistent with the conduct of their international business operations.

In a typical arrangement within a group, the I.P. Company licenses the use of the I.P. to other members. Royalties paid by the other group members (including the U.S. parent, if total ownership of the I.P. is assumed by the I.P. Company) is claimed as a deduction in the tax jurisdictions of each member that is a licensee. If an I.P. Box Company arrangement is in place or a special ruling obtained, the royalties received by the I.P. Company will be subject to a low tax rate. Assuming that arrangements are in place to remove the royalty income from the category of Foreign Personal Holding Company Income for purposes of Subpart F, the net result is reduced tax for book and tax purposes. This yields greater profits for the multinational group and increased value for its shareholders.

Two cases that are currently in litigation illustrate the I.R.S. scrutiny given to transfers of I.P. to an I.P. Company and the resulting U.S. tax issues that are encountered. The cases involve Zimmer Holdings and Medtronic.

Both cases developed within the backdrop of I.R.S. scrutiny given to corporations that converted Code §936 operations to C.F.C.'s during the ten-year period after the repeal of Code §936. In its heyday, Code §936 complemented a local tax holiday program in Puerto Rico by providing a tax sparing foreign tax credit to U.S. companies categorized as possessions corporations in connection with possessions source income. The principal U.S. possession for this purpose was Puerto Rico. In 2007, the I.R.S. issued its Industry Directive on Section 936 Exit Strategies (the "936 Directive"), which sets forth its position regarding ancillary issues for transfers of possessions corporation businesses and assets to foreign

affiliates. These issues included Code §§367(d) (relating to transfers of I.P. to a foreign entity in a tax-free transaction), 482 (relating to ongoing transfer pricing issues), and Subpart F (relating to issues involving C.F.C.'s that succeed to the business of the possessions corporation). The 936 Directive identified three types of issues that should be examined in a mandatory audit:

1. Whether the possessions corporation contributed any intangible property to the successor C.F.C. in connection with its conversion from a domestic U.S. corporation to a C.F.C. that should give rise to an imputed royalty under Code §367(d);

2. Whether the successor C.F.C. paid an arm's length royalty under a license or an arm's buy-in royalty under a cost sharing agreement with respect to its acquisition of I.P. from the U.S. group member that owned the I.P. following the conversion to a C.F.C.; and

3. Whether the C.F.C.'s prices for products manufactured or for services rendered were arm's length under Code §482.

The 936 Directive instructs international examiners to test whether gains from any transfers of goodwill and going concern value qualify as foreign source income for foreign tax credit purposes and calls for arm's length valuations of any goodwill or going concern value to the extent that these intangibles affect the C.F.C.'s subsequent pricing of its inventory and services.

With respect to Code §482, the I.R.S.'s international examiners were directed to limit income for most successor C.F.C.'s to a routine return with respect to the performance of manufacturing service functions. By doing so, all profits in excess of the routine return would be allocated back to the U.S. Use of a transfer pricing method for I.P., such as the foregone profits method, would accomplish this.

ZIMMER HOLDINGS

The first case involves Zimmer Holdings Inc., a U.S.-based manufacturer and seller of medical devices. In its Tax Court petition, it is challenging an I.R.S. assessment of additional tax in the amount of $79 million for tax years 2005 through 2007. A Dutch subsidiary of Zimmer succeeded to the legacy Puerto Rican manufacturing operations of the possessions corporation. Zimmer transferred ownership of I.P. to the Dutch subsidiary for use in conjunction with that company's manufacture and sale of products. The Dutch subsidiary also licensed the same I.P. to Zimmer for use in U.S. operations.

The I.R.S. took three different approaches to assessing additional U.S. tax with respect to the transfer of I.P. to the Dutch subsidiary and the license back of the same I.P. from the Dutch subsidiary.

Transfer Pricing Adjustments

The primary basis for the I.R.S. assessment was the Code §482 transfer pricing rules. A transfer pricing adjustment of $108 million was proposed for 2006 and a second adjustment for $120.5 million in 2007. The I.R.S. asserted that the royalty payments claimed as deductions by the U.S. parent were in excess of an arm's

length rate. The I.R.S. asserted that Zimmer should have used the Comparable Profits Method ("C.P.M.") for determining the royalty amount.

The C.P.M., under Code §482, looks to an arm's length range of comparable profits determined by the appropriate profit level indicators, such as gross margin and operating margin. The range is based upon objective measures of profitability and is derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The indicators are applied to the taxpayer's financial data to determine a comparable operating profit. Whether an uncontrolled taxpayer will be treated as comparable depends on such factors as the relevant lines of business engaged in by the uncontrolled taxpayer and its functions, resources, and risks relative to those of the taxpayer.[53]

Zimmer's position is that the I.R.S.'s application of the C.P.M. was incorrect because the I.R.S. failed to recognize that the U.S. taxpayer was indemnified for all liabilities, claims, losses, and costs.

Toll Charge on Transfer of I.P. to Offshore Corporate Affiliate

Alternatively, the I.R.S. attacked the transfer of the I.P. from the U.S. group to a Dutch subsidiary in 2004. The I.R.S. position was based on Code §§367(d) and (a). Initially, the I.R.S. asserted that I.P. was transferred from a U.S. corporation to a non-U.S. related corporation in a transaction that was subject to Code §367(d). The rules of §367(d) apply only if intangible property is transferred by a U.S. person to a foreign corporation in a tax-free exchange described in Code §351 or Code §361. The term "intangible property" as used in Code §367(d) is defined by reference to Code §936(h)(3)(B), which provides that the following items constitute intangible property:

- A patent, invention, formula, process, design, pattern, or know-how;
- A copyright, literary, musical or artistic composition;
- A trademark, trade name or brand name;
- A franchise, license or contract;
- A method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; and
- Any similar item.

Code §367(d) provides that the U.S. transferor is treated as having sold the intangible property in exchange for deemed annual payments that are contingent on the productivity, use, or disposition of the intangible property and that are commensurate with the income attributable to the intangible property. This means that each year the U.S. transferor must include in income amounts that represent an appropriate arm's length charge for the use of the intangible property, much like

[53] Treas. Reg. §1.482-5.

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an annual royalty. The regulations state that the appropriate charge is determined in accordance with transfer pricing rules of Code §482. The taxable amounts are characterized as ordinary income of the U.S. transferor. Interestingly, the Code §367(d) adjustments asserted by the I.R.S. were greater than adjustments provided for under the Code §482 regulations.

Zimmer contended that it did not transfer I.P. to its foreign corporate affiliate, but rather it transferred tangible and other assets, so that Code §367(d) was not applicable. I.P. may have been developed later by the I.P. Company, but Zimmer asserted it was not originally transferred by the U.S. taxpayer. In essence, it argued that any transfer that may have taken place predated the creation of the I.P.

Transfer of Assets to Offshore Corporate Affiliate

The I.R.S. alternatively asserted that if no I.P. were transferred, then Code §367(a) applied, resulting in gain recognition in the year of the transfer. An exchange is within the scope of Code §367(a) if it is in connection with a "transfer" of "property" to a "foreign corporation." The I.R.S. asserted that this type of transfer occurred and that Code §367(a) overrides other nonrecognition rules, such as Code §351.

In response, Zimmer observed that Code §367(a) does not apply to tax a transfer if the transferred property is used in an active trade or business conducted outside the U.S. Zimmer claimed that it had transferred a real business operation with real employees, which was an active business and Code §367(a) did not apply.

Zimmer's petition was filed with the Tax Court on Aug. 13, 2014 and signals the start of what is likely to be a long and complex lawsuit.

MEDTRONIC

Medtronic is a U.S. multinational that has recently received press coverage for its pursuit of a possible inversion transaction with Covidian. The surviving entity in the corporate transaction is intended to be an Irish tax resident, resulting in group headquarters being moved to Ireland.[54]

Medtronic is embroiled in litigation challenging an I.R.S. deficiency which concluded that the company had underreported its taxable income by over $1 billion in 2005 and 2006. The basis of the I.R.S. position is the arm's length transfer pricing rules of Code §482. The I.R.S. applied those rules to the U.S. parent's license of I.P. to its Puerto Rican operating subsidiary.

The Medtronic tax litigation involves several transfer pricing issues related to Puerto Rican operations. The I.R.S. made adjustments to the royalty paid under the licenses of intangible property from Medtronic U.S. to its Puerto Rican manufacturers. According to the I.R.S., the royalty payments exceeded an arm's length amount. This was surprising because the I.R.S. and Medtronic signed a

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[54] Medtronic's Tax Inversion Lesson, Aug. 13, 2014 W.S. J. reproduced in, http://online.wsj.com/articles/medtronics-tax-lesson-1407883241.

memorandum of understanding relating to a 2000 to 2002 audit of the very same licensing arrangement. In reliance on that memorandum, Medtronic amended its 2003 and 2004 tax returns to incorporate the memorandum of understanding and then used it in preparing its 2005 and 2006 returns. Initially, the I.R.S. accepted the pricing methodology in the memorandum of understanding. However, the I.R.S. changed its audit team and made adjustments for the years 2005 and 2006 that effectively modified the methodology agreed upon in the memorandum of understanding. In response, the taxpayer took affirmative steps to use a methodology that predated the memorandum of understanding. Ultimately, adjustments were made by the I.R.S. for the years 2003 and 2004. As Medtronic found out, a change in the I.R.S. audit team can have terrible results as all agreements and understandings reached in prior years no longer have value.

"To prepare for potential I.R.S. audit issues, multinational groups may wish to consider use of a 'concept to customer' strategy regarding I.P."

While many of the issues faced by Medtronic differ from those encountered by Zimmer, it is undeniable that the issues of both taxpayers reflect the hardline approaches of the I.R.S. that are expressed in the 936 Directive for possessions corporations. It is likely not a coincidence that the I.R.S. moved away from the transfer pricing methodologies of the memorandum of understanding after the 936 Directive was issued.

CONCLUSION

The litigation issues facing Zimmer and Medtronic have arisen in the specific context of Code §936 conversions. Nonetheless, these cases illustrate the I.R.S. willingness to contest taxpayers' choices of the best method of transfer pricing. They reflect a reprise of the I.R.S. litigation position in the "contract manufacturing" and "round tripping" cases from the 1980's (*e.g.*, *Eli Lilly and Sundstrand*) under the framework of Code §§482 and 367.

To prepare for potential I.R.S. audit issues, multinational groups may wish to consider use of a "concept to customer" strategy regarding I.P. The strategy involves the following steps:

- Maintaining a robust inventory of I.P. used in the business;
- Knowing where the I.P. is being used and understanding how it generates business profits;
- Tracking I.P. development expenses on a contemporaneous basis, and allocating the expenses to specific projects and product line profitability accounts; and
- Recording on a management-team basis and on a legal-entity basis the specific entities that contribute to I.P. development and describing technically and in management terms the scope of those contributions.