

## Recent Transfer Pricing Cases

A number of transfer pricing cases have been docketed in recent years. Some are awaiting trial while others have settled. The court filings provide insights into positions taken by taxpayers and issues the IRS considers worthy of litigating.

The most significant area of dispute concerns identification of compensable intangibles transferred by U.S. corporations to foreign subsidiaries and the pricing of those intangibles. This issue has arisen with buy-ins pursuant to cost-sharing arrangements and incorporation of foreign branches.

An important pending case is *Amazon.com Inc.*<sup>1</sup> Amazon entered into a cost-sharing arrangement (“CSA”) under the prior 1995 cost-sharing regulations with its Luxembourg subsidiary. The subsidiary was entitled to exploit the intangibles in Europe. In connection with entering the CSA, Amazon assigned pre-existing intangibles to the Luxembourg subsidiary pursuant to a license for a buy-in payment of \$217 million. The IRS asserts that the buy-in amount should be increased to \$3.6 billion. The taxpayer valued the intangibles as separate assets with a limited useful life, while the IRS arrived at its value based on the theory that a business was transferred to the foreign subsidiary, treating the intangibles as having a perpetual life and including value for items other than the separately identifiable intangibles.

The IRS previously made the same arguments in *Veritas Software Corp.*<sup>2</sup> The Tax Court rejected the IRS’s aggregation, transfer-of-a-business approach, holding that “no buy-in payment is required for subsequently developed intangibles” as well as items such as workforce in place, goodwill and business synergies that do not meet the definition of “intangible” as set forth in Code Sec. 936(h)(3)(B). As a result, the Tax Court also rejected the IRS’s use of the income method of valuation. Instead, it adopted the taxpayer’s position of separately valuing the pre-existing intangibles (within the meaning of Code Sec. 936(h)(3)(B)) with a limited life. The IRS subsequently issued temporary regulations reflecting its theories and specifying the income method. Thus, it seems somewhat odd that the *Amazon* case never made it to Appeals and that the IRS would chose to expend its limited resources re-litigating its position under the superseded 1995 regulations, especially after losing in *Veritas* as well as prior defeats regarding business opportunities.<sup>3</sup>

The IRS similarly is asserting large transfer pricing adjustments related to the incorporation of Puerto Rico branches following the repeal of Code Sec. 936.<sup>4</sup> In those cases, the IRS argues that the U.S. parent should have significantly greater income with respect to transactions involving products purchased from its foreign subsidiaries and intangibles licensed to its foreign subsidiaries. In the alternative, the IRS argues that intangible property was transferred to the foreign subsidiaries and subject to Code Sec. 367(d). That section requires a taxpayer to treat a transfer of intangible property (as defined in Code Sec. 936(h)(3)(B)) as a sale of the property for an arm’s-length amount of contingent payments over the life of the intangible property. The taxpayers in these cases take the position that the intercompany transactions are arm’s length, and that even if Code Sec. 367(d) applies, most of the value is attributable to foreign goodwill and going concern value, which is not subject to that provision.<sup>5</sup>



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Another high profile case is *Eaton Corp.*<sup>6</sup> Eaton is an industrial and aerospace manufacturer. It had obtained advance pricing agreements providing the transfer pricing methodology for certain products manufactured in Puerto Rico and the Dominican Republic and sold to U.S. affiliates. The IRS cancelled the advance pricing agreements and under a new transfer pricing methodology proposed a \$368 million adjustment (and penalties). The IRS alleges that Eaton failed to meet its compliance obligations and intentionally deviated from the terms of the advance pricing agreements, and the Tax Court will decide whether the IRS abused its discretion in cancelling the agreements.

In *Caterpillar Inc.*,<sup>7</sup> the IRS proposed to increase the amount of royalties earned by a U.S. corporation from two foreign subsidiaries. The taxpayer licensed a French and Belgian subsidiary the rights to use patents, manufacturing methods, trademarks and copyrighted materials. The royalty rate was five percent of net sales less certain expenses. The foreign subsidiaries suffered significant losses during an economic downturn and as a result of manufacturing inefficiencies, and the company undertook a major reorganization of the operations. Pursuant to renegotiated license agreements, Caterpillar suspended royalty payments from the foreign subsidiaries until they

returned to profitability. The IRS asserted that the U.S. parent's waiver of royalties was not arm's length, pointing to licenses the company had with a joint venture, but the taxpayer argued that third parties under comparable circumstances would have received royalty relief to permit the manufacturer to become profitable. The case recently was settled, allowing Caterpillar to exclude from income a substantial portion of the amount of the royalties waived.<sup>8</sup>

*Altera Corp.*<sup>9</sup> is another cost-sharing case that relitigates an old law issue, but this time with the benefit of new regulations being in effect. Often overlooked in the policy debates about cost sharing is that a U.S. cost-share participant effectively foregoes U.S. deductions to the extent of the foreign participant's share of the cost pool. In *Xilinx*<sup>10</sup> the Tax Court and Ninth Circuit rejected the government's argument that stock-based compensation should be included in costs taken into account under a cost-sharing arrangement. The regulations were subsequently amended in 2003 to require inclusion of such costs. Altera is challenging the validity of the revised cost-sharing regulations under some interesting theories, which, if adopted by the Tax Court, could have a far reaching effect on the regulation-writing process.

The above transfer pricing cases will be interesting to follow, and keep your eyes open for new cases.<sup>11</sup>

## ENDNOTES

<sup>1</sup> *Amazon.com Inc.*, TC Dkt. No. 31197-12.

<sup>2</sup> *Veritas Software Corp.*, 133 TC 297, Dec. 59,575 (2009).

<sup>3</sup> *Hospital Corp. of America*, 81 TC 520, Dec. 40,476 (1983); *Merck & Co., Inc.*, CtCl, 91-2

USTC ¶150,456, 24 ClsCt 73. See also Gupta, *Pride and Prejudice in Amazon*, 75 TAX NOTES INT'L 174 (July 21, 2014) ("it is unclear...what the IRS is fighting for in the Amazon case... in light of the case's limited precedential

value..."); Yoder and Lewis, "Properly Valuing Intangibles Transferred to Foreign Subsidiaries," 143 Tax Notes 470 (April 28, 2014).

<sup>4</sup> *Medtronic Inc.*, TC Dkt. No. 6944-11; *Guidant Corp.*, TC Dkt. No. 5989-11; *Abbott Labs*, TC

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<sup>5</sup> See also *First Data Corp.*, TC Dkt. No. 007042-09 (U.S. taxpayer transferred a foreign delivery business to a foreign subsidiary and treated 97 percent of the value as attributable to foreign goodwill and going concern value not subject to Code Sec. 367(d); the IRS asserted that most of the value—including network agreements and workforce in place—was subject to Code Sec. 367(d); the case has settled); Lowell D. Yoder, *Disputed Issues with the Application*

*of Code Sec. 367 to Intangibles*, INT'L TAX J., Jan.-Feb. 2012, at 3.

<sup>6</sup> *Eaton Corp.*, TC Dkt. No. 5576-12.

<sup>7</sup> *Caterpillar Inc.*, TC Dkt. No. 10790-13.

<sup>8</sup> In a second royalty case, the IRS in *3M Co.*, TC Dkt. No. 005816-3, argues that Code Sec. 482 requires blocked royalty payments to be included in income. The taxpayer is challenging regulations that sought to overrule several cases holding that Code Sec. 482 did not apply to blocked income. See Lowell D.

Yoder, *Blocked Income Controversy*, INT'L TAX J., Nov.-Dec. 2013, at 3.

<sup>9</sup> *Altera Corp.*, TC Dkt. Nos. 5576-12, 6253-2 and 9963-12.

<sup>10</sup> *Xilinx, Inc.*, 125 TC 37, Dec. 56,129; *aff'd*, CA-9, 2010-1 USTC ¶150,302, 598 F3d 1191.

<sup>11</sup> Just before sending this article to the publisher, a petition was filed in Tax Court challenging IRS proposed adjustments under sections 482 and 367(d). *Zimmer Holdings Inc. v. Comm'r*, T.C. Dkt. No. 19073-14.

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