# Transfer Pricing Litigation Update; Amazon, Medtronic, Other Recent Cases and New IRS Guidance

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# Themes of the Transfer Pricing Cases

1. Valuation of Intangibles
2. Evolving IRS Approaches to Transfer Pricing
3. Weakening of the Arm's-Length Standard

# Revenue Problems Among OECD Countries

- A tension exists between tax administrators' notion of realistic alternatives/sound economics and taxpayers' rights to arrange their business affairs to minimize taxes. The gap in the statutory rate and the effective rate of more than 20% is driving OECD countries, including the United States, to look for other ways to close the revenue gaps. This tension has resulted in a movement away from the arm's length standard and becomes readily apparent in the intangible area, particularly in light of the concept of "realistic alternatives" in the 2009 section 482 regulations.

# Revenue Problems Among OECD Countries (cont'd)

- Although the arm's length principle is universally accepted among OECD countries, there are differences in the way members view arm's length. The United States has traditionally respected contracts as written as long as they were followed. Internationally, the arm's-length principle is stretched to include the idea of whether parties operating at arm's-length would ever even enter into the contract.

- Base Erosion Profit Shifting ("BEPS") effort underway at the OECD. Action 8 involves special considerations for intangibles and addresses the lack of distinction between ex-ante (forecast) and ex-post returns (actual). There are divergent views among most OECD members and the United States on this issue. The United States takes the view that only the ex-ante is relevant whereas other members think both are relevant for hard to value intangibles. However, based on our experience with IRS exam teams on this issue, the difference may be more academic than real.

# U.S. Approach to Platform Contributions or "Buy-In" Payments

- In the U.S. context, there is disagreement between the IRS and taxpayers as to how to evaluate intangibles for purposes of the buy-in payment for cost sharing agreements.
- For example, the IRS asserts that in certain cases the following may be intangibles within the meaning of section 936(h)(3)(B) and thus be valued separately for purposes of the buy in payment:
  - Workforce in place
  - Goodwill
  - Value of the head start afforded by the pre-existing intangibles (R&D rights)
  - Make or sell rights
- The IRS view is that an experienced team in place may contribute value in excess of the compensation paid to individual team members, and therefore may constitute an intangible within the meaning of section 936(h)(3)(B). Taxpayers, on the other hand view it as a part of services for which there are established comparables available to determine the proper pricing.

# New IRS Guidance on Transfer Pricing Audits

The IRS released an audit "Roadmap" on February 14, 2014. The Roadmap, also called a "Quality Examination Process" (QEP), envisions a standard 24 month process (which may vary depending on the facts of the circumstances of an audit) for the audit process from start to finish. The IRS will spend an additional four months prior to the audit to become familiar with the taxpayer's business, operations, and market.

# Pre-Examination Analysis

- The first phase of the Roadmap is the "pre-examination analysis"
- To last about six (6) months.
- The Opening Conference and Transfer Pricing Orientation marks the beginning of this phase. During the pre-examination analysis stage, the IRS is to do the following:

1. Review tax returns for controlled transactions.
   - The IRS is supposed to learn the taxpayer's business including background, history, core business operations, IP, geographic and organizational structure, and segmented operational profitability.
   - Note that background analysis may include obtaining information from Treaty partners using requests for information pursuant to treaties or pursuant to simultaneous examination program.

2. Section 6662(e) documentation review.
   - IRS economist along with the International Examiner ("IE") and Transfer Pricing Practice member ("TPP") will begin to evaluate the taxpayer's best method and the potential applicability of various methods.

3. Planning meetings. Conduct a preliminary meeting with the taxpayer. In the meeting, the IRS is to
   - Identify key taxpayer personnel.
   - Request accounting data and records
   - Discuss need for interviews of operations personnel
   - Discuss Information Document Request ("IDR") process

4. Preparation of Initial Risk Analysis- a preliminary risk analysis is performed to help the IRS determine if the case is worthy of further examination or whether a survey would be more appropriate.

# Execution Phase

- The second phase of the roadmap is the "Execution Phase." Primary task for the execution phase is fact finding.
- Ideally to last between twelve (12) and fifteen (15) months.
- Send Information Document Requests ("IDR's")
- Consistent with the new directive (LB&I-04-1113-009), the IRS will perform what's called a comparability and functional analysis (outlined in IRM 4.61.3.5.1) during the execution phase. To do this analysis, the IRS is to interview key personnel, perform site tours, and review and analyze key accounting data.
  - Functional analysis primarily looks at the price charged and the profits earned on transfer pricing transactions to ensure they are at arm's length.
  - The functional analysis is performed with all IRS hands-on-deck (IE, TC (Team Coordinator), TPP (Transfer Pricing Practice member), Economist, Engineer, and Field Counsel).

# Resolution Phase

- The third and final phase of the roadmap is the "Resolution Phase."
- This is to occur in the last six (6) months of the audit.
- The final Notice of Proposed Adjustment (NOPA) is to be provided to the taxpayer and a meeting should be held to understand the taxpayer's position.
- If the taxpayer disagrees with the IRS's NOPA, the IRS is supposed to explore pre-Appeals resolution opportunities, including fast track resolution.
- If issues remain unagreed, the IRS is to issue a Revenue Agent's Report (RAR) and a thirty-day letter along with case closing workpapers. After it receives the taxpayer's 30-day letter protest, the IRS is to address and rebut the taxpayer's positions.
- If an appeals conference is necessary, it ideally should occur within this phase.

# The IRS Seeks an Escape from Veritas

- One cannot preview the *Amazon* transfer pricing litigation without first discussing *Veritas v. Comm'r,* 133 T.C. 14 Docket No. 12075-0, December 10, 2009.

- *Veritas* was a case in which the IRS lost on a challenge to a buy-in payment relating to a software intangible. The Tax Court held that the IRS discounted cash flow method used the wrong useful life, the wrong discount rate, and an unrealistic growth rate to calculate the requisite buy-in payment.

- The IRS made things difficult for itself during the litigation. For example, more than a year after the Petition was filed, the IRS changed its transfer pricing method and discarded its expert.

- The Tax Court found that the IRS's discounted cash flow method yielded a growth rate that would have required a buy-in payment from Veritas's Irish subsidiary equal to 100 percent of its actual and projected income to Veritas U.S. through 2009 (transaction was in 1999), which would have resulted in $1.9 billion in losses over that period.

- Rather than appeal, the IRS filed an action on decision (AOD) that it would not acquiesce in either the result or the reasoning of the *Veritas* decision.

# The IRS Seeks an Escape from *VERITAS* (cont'd)

- The IRS AOD stated as follows: "[t]he court construes the buy-in to exclude any consideration of the future income value or value attributable to intangibles to be developed under a CSA apparently on the theory that such future income stream is already paid for through the participants' cost shares of ongoing R&D."

- In the IRS's view, the ongoing cost sharing payments only account for a portion of the value of the intangibles to be developed under the cost sharing arrangement. The balance of that value is attributable to the head start afforded by the pre-existing intangibles.

- The IRS contended the Tax Court's interpretation reads "for purposes of research in the intangible development area" out of the regulation. That is, by ignoring the contribution of pre-existing intangibles to the value of intangibles developed under a cost sharing arrangement, the Tax Court limits the value of pre-existing intangibles to their make or sell rights, and does not include any value related to R&D rights.

- The IRS argued that its interpretation that R&D rights must be compensated is anchored in the regulations in effect for the years at issue, not just in the 2009 cost sharing regulations.

# Amazon.com Inc. et al. v. Commissioner, T.C. Memo. 2014-149; Docket No. 31197-12

Presiding Judge: Judge Albert Lauber of the U.S. Tax Court (Appointed 2013).

Trial began November 3rd in Seattle.

Facts:

- Amazon did not receive a 30 day letter which means that the IRS did not give it an opportunity to go to IRS appeals or perhaps the parties agreed that appeals was not worthwhile.
- Amazon filed its Petition Dec. 28, 2012 for a redetermination of a $2.2 billion income adjustment related to a cost sharing arrangement with its subsidiary in Luxembourg.
- IRS increased Amazon's European subsidiary's "buy in" payment to Amazon for pre-existing technologies related to the operation of its European websites. The IRS took issue with the Amazon's transfer of intangible property to its European subsidiary as part of a 2004-06 restructuring and its formula and method for allocating costs for ongoing research and development under the cost share agreement.
- The cost sharing arrangement included a buy-in for preexisting technology and marketing intangibles that the IRS valued at more than 20 times the amount negotiated by Amazon and its subsidiary.
- Pre-existing intangibles included domain names, trade names, trademarks, website software, and fulfillment systems.

# Dueling Buy-In Payment Valuations

- Amazon engaged Deloitte Tax LLP (Deloitte) to conduct a transfer pricing study and value the pre-existing intangible property. The transfer pricing study concluded that the present value of the buy-in payment on behalf of the Luxembourg affiliate to Amazon was $217 million as of January 1, 2005.

- Amazon's Deloitte valuation was based on a useful life for the pre-existing intangibles of no more than seven years.

- Assumed the value of the intangibles would decay over the seven-year useful life.

- Amazon did not separately value the items of pre-existing intangible property subject to the buy-in and instead valued the property in the aggregate.

- Deloitte used a 13 percent discount rate used to determine the present value of the buy-in payment.

- Based on the transfer pricing study, the Luxembourg affiliate agreed to make buy-in payments with a cumulative present value of $217 million over a seven-year period beginning in 2005. The 2005 payment was $73 million and the 2006 payment was $83 million.

# Dueling Buy-In Payment Valuations (cont'd)

The IRS hired Horst Frisch to perform its valuation. Horst Frisch:

- Applied the discounted cash flow (DCF) method as an unspecified method under Treas. Reg. § 1.482-4(d).
- Used same European website operating profit projections that were identified by Deloitte in its transfer pricing study.
- Used a 3.8 percent terminal growth rate.
- Used a 18 percent discount rate
- Like Deloitte, valued the intangibles in the aggregate.

Horst Frisch determined that the value of the pre-existing intangibles as of January 1, 2005 was **$3.6 billion**. Converted that value to buy-in payments over a seven-year period.

# Amazon's Pre-Trial Maneuvering

- Amazon sought summary judgment on
  - Whether the IRS could categorically require inclusion of 100 percent of certain cost centers in the IDC pool under Treas. Reg. § 1.482-7A(b)(2) without using any allocation methodology and without specifically identifying the included costs as IDCs; and
  - Whether Amazon was entitled as a matter of law to apply an allocation method to determine IDCs under Treas. Reg. § 1.482-7A(b)(2) because its accounting books and records do not specifically identify costs related to the intangible development area.
- Court denied motion: "Because there is a genuine dispute of material fact as to whether, and the extent to which, the cost centers at issue constitute 'mixed costs,' we will deny petitioner's motion for partial summary judgment on both questions."
- Amazon also sought to amend its petition to allow a new method to allocate its intangible development costs. Court denied as being prejudicial to Respondent since it was sought 15 months after Amazon filed its petition.

# Amazon's Pre-Trial Maneuvering (cont'd)

- Amazon moved to depose an economist from the firm who performed the IRS valuation (Horst Frisch) who now works at the IRS in an effort to obtain evidence of "early conversations and decisions relating to what approaches might be feasible for the IRS in the aftermath of *Veritas*.

- Amazon filed a motion to compel production of the IRS's internal training materials on transfer pricing.

- Amazon also filed a motion to compel for the IRS's administrative file and for documents for which the IRS claimed deliberative privilege. The Court upheld 85 of the 100 documents for which the IRS claimed privilege.

- The IRS sought production of documents relating to Amazon's allocation of intangible development costs. Court denied as overly burdensome but allowed selected discovery on the issue.

# Amazon's Cost Share Formula

- The wholly owned Luxembourg subsidiary had the rights to exploit the co-developed intangible property in Europe and Amazon reserved the rights to exploit the intangible property in the rest of the world.
- The parties agreed to share and allocate intangible development costs and costs which contribute both to intangible development activity and other business activities on a reasonable basis. 1.482-7(d)(1).
- Under the cost sharing agreement, Amazon used a formula to calculate the Reasonably Anticipated Benefits (RAB) shares based on revenues generated.

# Amazon's Cost Share Formula (cont'd)

- Amazon failed to segregate its intangible development costs from other operating costs so it developed and applied a formula to allocate to its intangible development costs a portion of the costs accumulated in various costs centers. Costs centers were accounting classifications that enabled it to manage measure operating expenses. These expenses came in 6 categories:
  - Cost of sales
  - Fulfillment
  - Marketing
  - Technology and content
  - General and administrative; and
  - Other.

# Amazon's Cost Share Formula (cont'd)

- The IRS challenged the allocation as it related to the technical and content costs. T&C category expenses "consist principally of payroll and related expenses for employees involved in research and development, including application development, editorial content, merchandising selection, systems and telecommunications support, and costs associated with the systems and telecommunications infrastructure.

- The IRS determined that 100% of the T&C category were IDCs. Amazon contends that the T&C categories were mixed costs.

- The IRS also challenged the formula used by Amazon to allocate the IDCs.

# Key Issues at Trial

- Whether the useful life of pre-existing intangibles for purposes of developing future intangibles is perpetual or not.
- The IRS's use of the income method (IRS used DCF method). *Veritas* had cast doubt on this method.
- If the decision is broad, it could help the IRS overcome *Veritas*. If narrow, it will much less helpful.

# Medtronic Inc. v. Commissioner, T.C. Docket No. 6944-11 (2011).

Presiding Judge: Judge Kathleen Kerrigan of the U.S. Tax Court (Appointed 2012).

Set for Trial in February, 2015 in Chicago.

Facts:

- Petition filed 3/23/11
- According to the notice of deficiency issued December 23, 2010, Medtronic's Cayman Island CFC failed to make arm's length payments to Medtronic U.S. for licensing intangibles and purchasing components used in manufacturing pulse generators and leads for tax years 2005 and 2006.
- IRS proposed to increase Medtronic's income by $496.5 million in 2005 and $750.7 million in 2006. There are over $2 billion in transfer pricing adjustments at stake.
- Medtronic's Cayman Island CFC owned a Puerto Rican manufacturing subsidiary which manufactures medical devices for several foreign jurisdictions and the U.S market. The IRS maintains that that the Cayman Island CFC and its Puerto Rican manufacturing subsidiary are a sub-manufacturer rather than an autonomous, risk-bearing entity. Medtronic maintained that its Puerto Rican operations represent "an entrepreneurial, risk-bearing, and functionally autonomous licensed manufacturer."

## Alternative IRS Theories

- As an alternative to section 482, the IRS asserted that a section 367(d) inclusion is required if the Commissioner's section 482 position related to the Devices and Leads Transfer Pricing Issue is not upheld by the Court. As a reminder, section 367(d) treats the taxpayer as having sold the intangible property in exchange for payments over the useful life of such property and commensurate with the income attributable to the intangible.

- Section 965 Dividends Received Deduction Issue: During 2006, Medtronic received cash dividends from its controlled foreign corporations totaling $1,310,010,463. Of this amount, dividends totaling $933,700,000 were qualifying dividends under section 965(b) (the "Section 965 Dividends"). In accordance with section 965, Medtronic claimed a dividends received deduction in 2006 for the Section 965 Dividends in the amount of $793,645,000.

- The IRS argues that Medtronic's taxable income since 2003 created "existing or potential" intercompany accounts receivable under the principles of Revenue Procedure 99-32, 1999-2 C.B. 296, which constituted "related party indebtedness" under section 965(b)(3) and disallowed Medtronic's dividends received deduction for the Section 965 Dividends and increased Medtronic's income by $793,645,000 for 2006. We will discuss this provision in more detail with respect to a Fifth Circuit case *infra*.

# Medtronic's Motion for Summary Judgment

Medtronic moved for summary judgment as a matter of law that the IRS adjustments was arbitrary, capricious, or unreasonable b/c the IRS had:

- Entered into a Memorandum of Understanding (MOU) with Medtronic with respect to the Puerto Rico operations which included an agreement with respect to the arm's length royalty rates during three separate audits (2002, 2003, 2004).

- For the 2005-2006 tax years, the IRS again made a determination that the Puerto Rico MOU reflected "arm's length" royalty rates.

- During a second examination of the 2005-2006 tax years, the IRS changed its mind. Its new determinations in support of the Notice of Deficiency more than doubled the amounts that it had determined were "arm's length" in March 2009 for 2005 and more than tripled the amounts it had determined were "arm's length" in March 2009 for 2006.

# Medtronic's Motion for Summary Judgment (cont'd)

- Argued that any transfer of goodwill or going concern value, including workforce in place, to Medtronic Puerto Rico by Med Rel, Inc., and Medtronic Puerto Rico, Inc., was exempt from royalty imputation under section 367(d), because these assets were 100 percent foreign assets.

- In the alternative, Medtronic argued that these assets were already valued by the IRS during its examination of Medtronic's 2002 tax return. Medtronic did not contest the IRS's valuation and factual determinations made under section 367(d) with respect to Medtronic's 2002 tax year and included the resulting section 367(d) amounts in its 2005 and 2006 tax returns.

- Summary of argument w/respect to section 965: On December 7, 2010, Medtronic US, Medtronic Europe, and the IRS entered into the Buy-In Closing Agreement, resolving the Medtronic Europe Buy-In issue. Under the terms of the Buy-In Closing Agreement, the parties agreed to increase Medtronic's taxable income and earnings and profits for 1999. Subject to express contingencies, the amount of the increased taxable income and earnings and profits was treated as though an intercompany account receivable from Medtronic Europe to Medtronic US was established as of the last day of 1999 and thus did not affect its dividend received deduction in an earlier year.

The Tax Court denied the motion.

# IRS's Motion for Partial Summary Judgment

- The IRS also moved for partial summary judgment on the alleged absence of economic substance in the purported risk indemnification agreement between Medtronic U.S and its wholly owned Puerto Rican entities because the intercompany agreements failed to transfer product liability risk under governing law.

- The Tax Court denied the motion on September 29th, 2014 ruling that there were material facts in dispute.

# Key Issues

- Although repudiating the MOU does not look good for the IRS, contract manufacturers, which the IRS argues Medtronic Puerto Rico is, are generally not entitled to premium returns.  Whether the court is willing to accept the contractual allocation of risk to the Puerto Rican operation will be crucial.

- The former head of the IRS's Transfer Pricing Practice has indicated that the IRS wants to close a perceived gap amongst taxpayers that there is a more restrictive definition of assets under section 367(d) that are subject to section 482.  This case could provide some clarity on this issue.

- If the decision is adverse to Medtronic, the case could have a chilling effect on MOU's or other method of settlements w/ respect to transfer pricing issues b/c of the ability of the IRS to repudiate later.

# Zimmer Holdings, Inc. v. Commissioner, T.C. Docket No. 19073-14 (2013)

- Filed a petition in the U.S. Tax Court contesting IRS transfer pricing deficiencies in the amount of $709,878 for 2005, $40,451,275 in 2006, and $38,114,578 for 2007.

- Zimmer had a CFC located in the Netherlands who owned a manufacturing branch. The IRS asserted that under section 482, Zimmer's income should be increased by $108 million and $120.5 million for 2006 and 2007, respectively.

- Alternatively, the IRS said that Zimmer's 2006 and 2007 taxable income should be increased by $111.5 million and $164.2 million, respectively, based on transfers of intangible property to its Dutch subsidiary under section 367(d).

- In a second alternative, the IRS determined that Zimmer's 2006 taxable income should be increased by $998.6 million, based on the value of licensing agreements, workforce-in-place, and goodwill allegedly transferred from one of Zimmer's U.S. subsidiaries to its Dutch subsidiary, for which Zimmer had a zero basis, under section 367(a)(1).

# *BMC Software Inc. v. Commissioner*, 141 T.C. No. 5 (2013).

- The 2004 repatriation program permitted U.S. corporations to bring home income held outside the U.S. at an effective rate of 5.25 percent instead of the top 35 percent corporate income tax rate.

- BMC, based in Houston, contended that accounts receivable (as a result of a closing agreement with the IRS) on its books should not be counted as debt that would reduce the amount of money it could bring to the U.S. from foreign affiliates at the reduced tax rate.

- Tax Court disagreed (Kroupa), ruling that the IRS's "treatment of the accounts receivable are consistent with the dictionary definition" and "may constitute indebtedness" for purposes of calculating how much in earnings could be taxed at the lower rate in effect at the time.

- BMC claimed $709 million in earnings qualified for the tax holiday. The IRS ruled that $43 million was ineligible for taxation at the lower rate because it represented a foreign unit's debt to BMC created by accounts receivable, according to court filings.

# BMC Software Inc. v. Commissioner, 141 T.C. No. 5 (2013) (cont'd)

- Underlying dispute began in late 2006, when BMC elected to bring $721 million held by its foreign subsidiary BMC Software European Holding into the U.S. under a "dividends-received deduction" Congress passed in 2004 as a stimulus measure designed to encourage major companies to repatriate overseas cash.

- Of the $721 million, nearly $709 million qualified for the tax holiday.

- In 2007, BMC entered into a deal with the IRS to resolve an unrelated transfer pricing dispute that increased the company's taxable income by $102 million during tax years 2003 through 2006.

- The settlement created an account imbalance between BMC and its foreign subsidiary, which the company resolved by creating $102 million in accounts receivable owed by BMC European Holding.

- BMC sought to square the company's accounts pursuant to Revenue Procedure 99-32 to avoid having the cash treated as a taxable dividend.

# BMC Software Inc. v. Commissioner, 141 T.C. No. 5 (2013) (cont'd)

- The IRS demanded that BMC retroactively reduce its deduction on the cash it repatriated in 2006. The IRS says that a provision of the tax holiday statute required that "related party debt" – such as accounts receivable – accrued between October 2004 and March 2006 had to be discounted from funds eligible for the deduction.
- BMC unsuccessfully argued that the accounts receivable were not related party debt and that even if they were, Congress only intended that related party debt created for the purpose of effectuating an intentionally abusive transaction had to be taken into account.
- As a result, BMC was required to reduce its funds subject to the dividends-received deduction by $43 million, which yielded a $13 million tax liability.
- BMC appealed the Tax Court decision to the Fifth Circuit.
- In recent oral arguments in September at the Fifth Circuit, Justice Reavley noted that Revenue Procedure 99-32 insulates a party from any adverse tax consequence flowing from squaring accounts, which he suggested likely prohibits the IRS from reducing BMC's 2006 deduction.

# Key Issues

- This case has larger implications because of the widespread use of the tax repatriation holiday and subsequent transfer pricing adjustments. Both Microsoft and Medtronic submitted amicus briefs in support of BMC's appeal.

- Closing agreement with the IRS specified that the transfer pricing adjustments would have no secondary effects for unrelated items.

- Key issue is when was the debt incurred? The taxpayer believes the IRS position flouts traditional tax rules w/respect to when debts are accrued.

# Caterpillar Inc. v. Commissioner, T.C. Docket No. 10790-13 (2013)

- The IRS issued a proposed adjustment that raised Caterpillar's U.S. taxable income by $55 million for royalties allegedly owed by its Belgian subsidiary, and by $27 million for royalties allegedly owed by its French subsidiary. The amounts reflected the full 5 percent royalty that would have been paid under the previous agreement in the 1992-1994 period.

- The dispute arose over Caterpillar's decision in 1990 to amend licensing agreements (originally signed in the 1960s) with its manufacturing subsidiaries in France and Belgium to suspend the subsidiaries' royalty obligations until they were profitable.

- The royalty rate of 5 percent had been determined on a value added basis (net sales less costs such as parts and components).

# Caterpillar Inc. v. Commissioner, T.C. Docket No. 10790-13 (2013)(cont'd)

- The amended licensing agreements suspended royalty payments in years during which the subsidiaries incurred net operating losses, and it allowed for the carry forward of NOLs to limit the royalty in future years. During the years in question, the subsidiaries incurred losses and, under the agreement, made either no or reduced royalty payments.

- Caterpillar said in its Tax Court petition that at the time of the amendments to the agreements, it was undergoing a prolonged period of weak sales and accumulating losses. It claimed that suspending the royalty payments was an arm's-length approach intended to help the foreign subsidiaries return to profitability.

- The IRS argued that the suspensions were not an arm's-length result, noting that the company had not suspended a similar royalty arrangement with its 50-percent-owned Japanese joint venture with Mitsubishi Heavy Industries Ltd.

- Caterpillar sought to resolve the matter through the competent authority provisions of the U.S. tax treaties with Belgium and France, but the competent authorities failed to reach agreement.

- In a February 28 stipulation, Caterpillar and the IRS agreed to adjust the company's U.S. taxable income. The parties agreed to an increase of $22 million for income from Caterpillar's Belgian subsidiary and $11 million for income from its French subsidiary.

## *Intersport Fashions West Inc. v. United States*, Fed. Cl., No. 07-739 (filed by the court Feb. 13, 2012), Doc. No. 2012-2983. *Intersport Fashions West Inc. v. U.S.*, Fed. Cir., No. 2012-5080, appeal docketed Apr. 19, 2012.

- Intersport filed two amended returns on which it replaced the claimed deductions for payments to its foreign parent Eurobike with its purported allocable share of restructuring expenses incurred by Eurobike, which were not reported on the taxpayer's original or "first return."
- Intersport claimed a total deduction for allocated expenses of $1.3 million for 2001 and $1.7 million for 2002, which would have resulted in a $393,992 decrease in its 2001 tax liability and a $583,354 decrease in its 2002 tax liability.
- The IRS denied the refund claim on the grounds that the deductions were barred by Treas. Reg. section 1.482-1(a)(3) since they were not claimed on initial "timely filed" returns.
- It has been a general administrative practice over a long period of time to recognize amended returns filed after the due date for the purpose of correcting clear errors or plain mistakes on original returns. For example, the filing of an amended return to increase deductions (unrelated to transfer pricing) is explicitly authorized by Treas. Reg. section 1.461-1(a)(3).

## *Intersport Fashions West Inc. v. United States*, Fed. Cl., No. 07-739 (filed by the court Feb. 13, 2012), Doc. No. 2012-2983. *Intersport Fashions West Inc. v. U.S.*, Fed. Cir., No. 2012-5080, appeal docketed Apr. 19, 2012. (cont'd)

- Intersport relied on the Tenth Circuit's 1963 holding in *United States v. Van Keppel*, 321 F.2d 717 (10th Cir. 1963), that it was an abuse of discretion for the IRS to refuse to accept an amended return correcting a mistake even though the regulation required the return to be timely filed.

- The Court of Claims rejected this argument, finding *Van Keppel* to be inconsistent with two Supreme Court cases, *Scaife Co. v. Commissioner*, 314 U.S. 459 (1941) and *Helvering v. Lerner Stores Corp.*, 314 U.S. 463 (1941) which allowed the IRS to deny amended returns when the regulation required a first return even though it involved a mistake in computation and despite any "hardship" that resulted.

## *Intersport Fashions West Inc. v. United States*, Fed. Cl., No. 07-739 (filed by the court Feb. 13, 2012), Doc. No. 2012-2983. *Intersport Fashions West Inc. v. U.S.*, Fed. Cir., No. 2012-5080, appeal docketed Apr. 19, 2012. (cont'd)

- The government successfully persuaded the Court of Claims to characterize the claim as an attempt to "allocate income" under section 482 and analogized the regulatory prohibition at Treas. Reg. section 1.482-1(a) against taxpayer-initiated favorable "allocations" on amended returns.
- The Court of Claims ultimately concluded that a favorable section 482 allocation of income can be initiated only by a taxpayer on an original or first return.
- Intersport has appealed the Court of Claims' decision to the U.S. Court of Appeals for the Federal Circuit.

*The interesting question raised by Intersport is whether taxpayers can be barred from amending returns to report actual results of controlled party transactions?*

# Altera Corp. v. Commissioner, T.C., Docket No. 6253-12 (2012).

- Petitions filed 3/6/2012 and 4/20/2012.

- After losing *Xilinx v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), which involved the prior costs sharing regulations, the IRS amended 1.482-7(d)(2) in 2003 to require the cost sharing of stock-based compensation.

- The regulation is contrary to the arm's length principle because there are numerous comparable transactions of unrelated parties where stock based compensation is not included in joint R&D agreements.

- The computer chip maker is challenging the validity of 2003 cost sharing regulations that explicitly require the inclusion of stock-based compensation in the cost pool.

# Eaton Corp. v. Commissioner, T.C. Docket No. 5576-12

- $368.6 million transfer pricing adjustment arising from the cancellation of two advance pricing agreements. Out of 1,000 APAs executed over the past 20 years, only 11 have been canceled or revoked.

- The industrial and aerospace manufacturer argues that the IRS abused its discretion in canceling the unilateral APAs involving the sale of "breaker products" from manufacturing operations in Puerto Rico and the Dominican Republic to its affiliates in the United States.

- In December, Eaton filed a series of motions—asking the court to reconsider its order denying the company access to key IRS internal memos, seeking partial summary judgment on the abuse of discretion issue, and opposing an IRS motion to bifurcate the trial into two proceedings. The IRS seeks separate trials on the merits of canceling the APAs and the adjustment itself.

# Eaton Corp. v. Commissioner, T.C. Docket No. 5576-12 (cont'd)

- A Dec. 15, 2011, transfer pricing study conducted for the IRS shows the profits in Eaton's Cayman Islands subsidiaries were 10 times the median return reported by comparable manufacturers.

- The IRS reallocated, to the U.S. subsidiary, 90 percent of the operating profits of Eaton's Cayman Islands operations.

- IRS questioned the functional analyses performed by Eaton and indicated in correspondence that Eaton was less than forthcoming in the documentation it provided.

- The IRS concluded that, in contrast to what was provided in the APAs, the tested party should be the Cayman Islands subsidiaries together, which would leave the profits and losses associated with the intangibles with the U.S. affiliate.

# Guidant LLC v. Commissioner, T.C. Docket No. 5898-11, 5990-11, 10985-11, 26876-11, 5501-12, 5502-12

- IRS is starting to challenge intercompany financing agreements that have the effect of shifting income to low tax jurisdictions.

- A consolidation of petitions filed by Boston Scientific and its subsidiaries Guidant LLC and Cardiac Pacemakers. Together the parties are protesting a total of $2.3 billion in IRS transfer pricing adjustments.

- IRS argues that the loans are not bona fide debt for federal income tax purposes

- Most documents are now subject to a protective order.

# 3M Company v. Commissioner, T.C. Docket No. 5816-13

- IRS allocated royalty income from a Brazilian subsidiary to its U.S. parent.

- 3M asserts that the royalty is prohibited under Brazilian law and argues that the IRS does not have the authority to reallocate income if foreign law prohibits payment or receipt. Under different facts, the U.S. Supreme Court held that the IRS does not have such authority, which the IRS sought to overrule with regulations.

- The validity of Treas. Reg. § 1.482-1(h)(2) is at issue.