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Transfer Pricing

Multinationals Cry Foul After IRS Backs Out of Agreements

Some of the best-known companies in the U.S. and the world dispute the IRS's characterization of expenses they can deduct from transactions with their foreign subsidiaries and the interpretation of their agreements with the agency over the pricing of those transactions.

Two transfer pricing cases pending before the U.S. Tax Court highlight corporate taxpayers' concerns over not only the dramatic transfer pricing adjustment amounts the Internal Revenue Service imposes on them, but also the agency's disregard of agreed-upon methodologies for reporting their transfer pricing.

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ELIZABETH MULLEN
MARCUM LLP

Coca-Cola Co. is battling a $9.4 billion transfer pricing adjustment connected to its licensing of trademarks, formulas and other intellectual property to related parties in Europe, Africa and South America (*Coca-Cola Co. v. Commissioner*, T.C., No. 31183-15, *petition filed* 12/14/15).

The Internal Revenue Service says Coca-Cola undercharged seven foreign affiliates for intellectual property—including trademarks and formulas—used in the production and sale of Coca-Cola concentrates abroad.

According to Coca-Cola, the company has used the same methodology for determining its U.S. taxable income from foreign company operations for nearly 30 years and formally agreed to the methodology in a closing agreement with the IRS.

Elizabeth Mullen, a tax partner at Marcum LLP in New York, told Bloomberg BNA that the *Coca-Cola* case highlights the fact that advance pricing agreements (APAs) between taxpayers and the IRS might not fully protect the methodology applied by the business to determine it is reflecting an arm's-length profit.

"If you have an agreement with the IRS, how good is it?" Mullen said. "The reason taxpayers go into an agreement is they want some assurance that they won't have a transfer pricing adjustment. I think the fact that the IRS canceled an APA is a pretty big deal."

The trial in *Coca-Cola* is set to begin in March 2018 in Washington. If the IRS prevails, the company could face a tax bill of as much as $3.3 billion, not including interest and potential penalties.

We Had an Agreement. Eaton Corp., an electrical equipment manufacturer, seeks to enforce two APAs the IRS canceled because the company withheld material information. According to Eaton, the APAs were improperly canceled, and the company seeks to eliminate a subsequent $368.6 million adjustment that led to $125 million in additional taxes and penalties (*Eaton Corp. v. Commissioner*, T.C., No. 5576-12, *petition filed* 2/29/12).

Mike Patton, a partner at DLA Piper in Los Angeles, told Bloomberg BNA he believes Eaton has a stronger argument in the dispute, and that he hopes the company's argument that its agreement with the agency was contractually binding prevails.

U.S. Tax Court Judge Diane Kroupa ruled in June 2013 that an APA is an "administrative determination" and thus the question of whether the agency acted properly must be determined under an "abuse of discretion" standard. Kroupa, who recently pleaded guilty on tax evasion charges, has been replaced by Judge Kathleen Kerrigan.

"I think if the government takes an action against a taxpayer, the government ought to be willing to stand up and say 'this is the reason for canceling the APA,' not that the taxpayer has the burden and the agency won't tell why they did what they did," Patton said.

Eaton also filed a second Tax Court petition involving the cancellation of APAs that led to $1 billion in adjustments for tax years 2007 to 2010. The IRS proposed adjustments totaling $872.5 million under tax code Section 482 or, in the alternative, $780 million under Section 367(d), which governs the transfer of intangibles.

The *Eaton* cases are pending in the Tax Court, with briefs filed by both parties.

Besides the IRS being obligated to respect APAs as contractually binding, Patton and Mullen both said that the amounts at issue in the cases are also a concern.

"The adjustments are so large that the taxpayers are willing to litigate them," Mullen said, adding that the IRS wouldn't necessarily prevail when the courts look at the methods applied in determining the proper transfer pricing.

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Patton said a lot of the transfer pricing adjustments are inflated because of income projections. ''The numbers are kind of like imaginary numbers.''

If history is any predictor, Patton said, the taxpayers in the *Coca-Cola* and *Eaton* cases will prevail because ''they are largely factual,'' and the taxpayers simply know the facts better.

Platform Development. Two of the internet's biggest players—Amazon.com Inc. and Facebook Inc.—are contesting the IRS's characterization of the value of intangible property related to platforms developed with their respective European subsidiaries.

Amazon, the earlier case, is unlikely to affect the recently filed *Facebook* case, because the IRS issued regulations under tax code Section 482 at the beginning of 2009 that effectively put an end to the ''buy-in'' arrangement used by Amazon, Neal Kochman, a member at Caplin & Drysdale in Washington, told Bloomberg BNA Dec. 2.

Amazon's dispute was tried in the U.S. Tax Court almost two years ago, and the parties are still waiting to hear how Judge Albert G. Lauber will decide how much of the cost associated with the development of technology for use in operating Amazon-branded websites in Europe will be allocated to the U.S. parent.

The central issue in *Amazon.com, Inc. v. Commissioner*, T.C., No. 31197-12, *petition filed* 12/28/12 is the validity of the discounted cash flow method used by the IRS to value intangibles transferred from Amazon to a Luxembourg affiliate under a restructuring that occurred in 2004-06. Amazon valued the transferred intangibles at $216 million; the IRS claimed they were worth $3.6 billion.

Amazon is relying on the Tax Court's decision in *Veritas Software Corp. v. Commissioner*, 2009 BL 266922, 133 T.C. 997 (2009),, which rejected the IRS's transfer of business approach and income method valuation. The IRS issued the new regulations before *Veritas* was decided and said it wouldn't follow the decision after it was issued.

Amazon and other taxpayers used the ''buy-in'' approach to transfer prior to 2009, because the transfer pricing regulations didn't provide any guidance on valuing intangibles in cost-sharing agreements between related parties, Kochman said.

The IRS and Amazon aren't the only ones waiting on the Tax Court decision—so is the European Union Competition Commission. If the Tax Court favors the IRS and consequently raises Amazon's U.S. tax bill, the commission may see less ''stateless'' income to be concerned about.

Facebook Under New Rules. Facebook filed its petition with the Tax Court two months ago (*Facebook, Inc. v. Commissioner*, T.C., No. 21959-16, *petition filed* 10/11/16). The IRS calculated that intangibles the company transferred to its Irish subsidiary were worth more than $13.8 billion—about twice the value Facebook placed on them, according to the petition.

The tax deficiency for 2010 amounts to only $1.7 million, but Facebook said the ultimate dollar impact of the audit could be much higher, because the IRS plans to apply its calculations for 2010 to later tax years as well. The company said it could be facing tax liabilities of between $3 billion and $5 billion for later years.

The same type of intangible property is involved in both cases; however, Facebook's transaction falls under the 2009 rules, which were finalized in 2011. The new rules under Treasury Regulations Section 1.482-4 set forth methods for valuing intangibles subject to development cost-sharing agreements between related parties.

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