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U.S. Transfer Pricing Developments

Litigation Update and Other Developments

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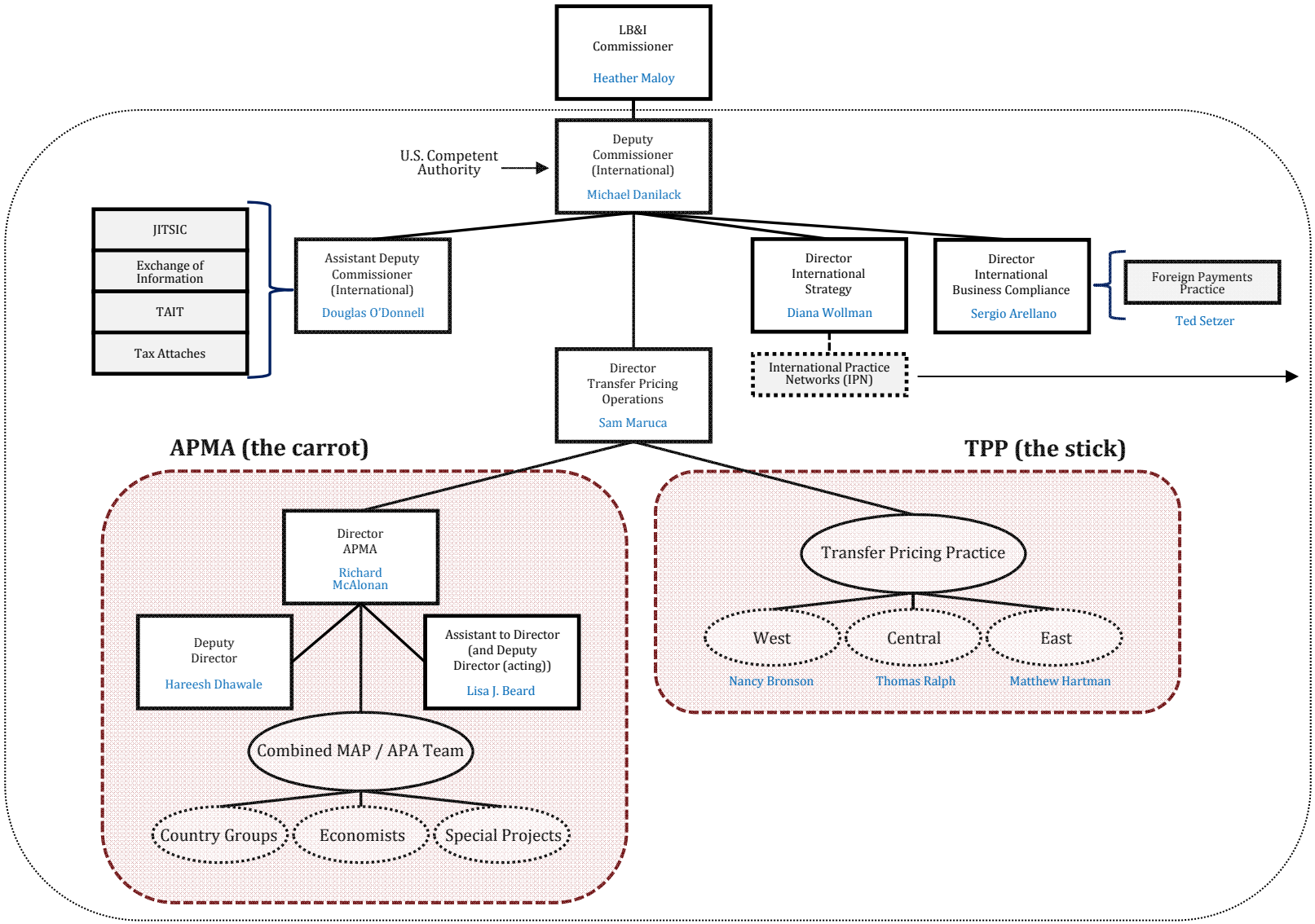
Agenda

- **Administrative update**
  - The reorganized IRS
  - Transfer Pricing Roadmap
  - Proposed MAP and APA revenue procedures
- **Transfer pricing cases of interest**
  - Eaton
  - 3M
  - Intersport Fashions West
  - BMC Software
  - Amazon.com

Administrative Update

Revised LB&I TP Organization



Reorganized IRS Highlights

- **Recent results under TPO structure**
  - Increased APA completions, reduced backlog and quicker processing times
  - MAP resolutions had high degree of double tax elimination with declining timeline for resolution though double tax inventory increased (likely attributable to India)
    - Notably, double the number of US-initiated double tax cases
  - Better relationship with some treaty partners, though resource constraints seen with some countries (budget / travel limitations, etc.)
- **MAP Forum**
- **TP in CAP?**
- **LB&I evolution from tiering to KM network**
  - Over past two years, LB&I has:
    - Abandoned the Tiered Issue Process – August 2012
    - Started development of International Practice Networks (IPNs) – ongoing
    - De-coordinated its Coordinated Issue Papers – January 2014
  - Decision-making in field coupled with collaborative / coordinated technical support

Knowledge Management

- **IPNs**
  - Two primary goals (1) to provide exam teams with advice for efficient / consistent / technical management of cases, and (2) foster collaboration and knowledge-sharing across LB&I and CC

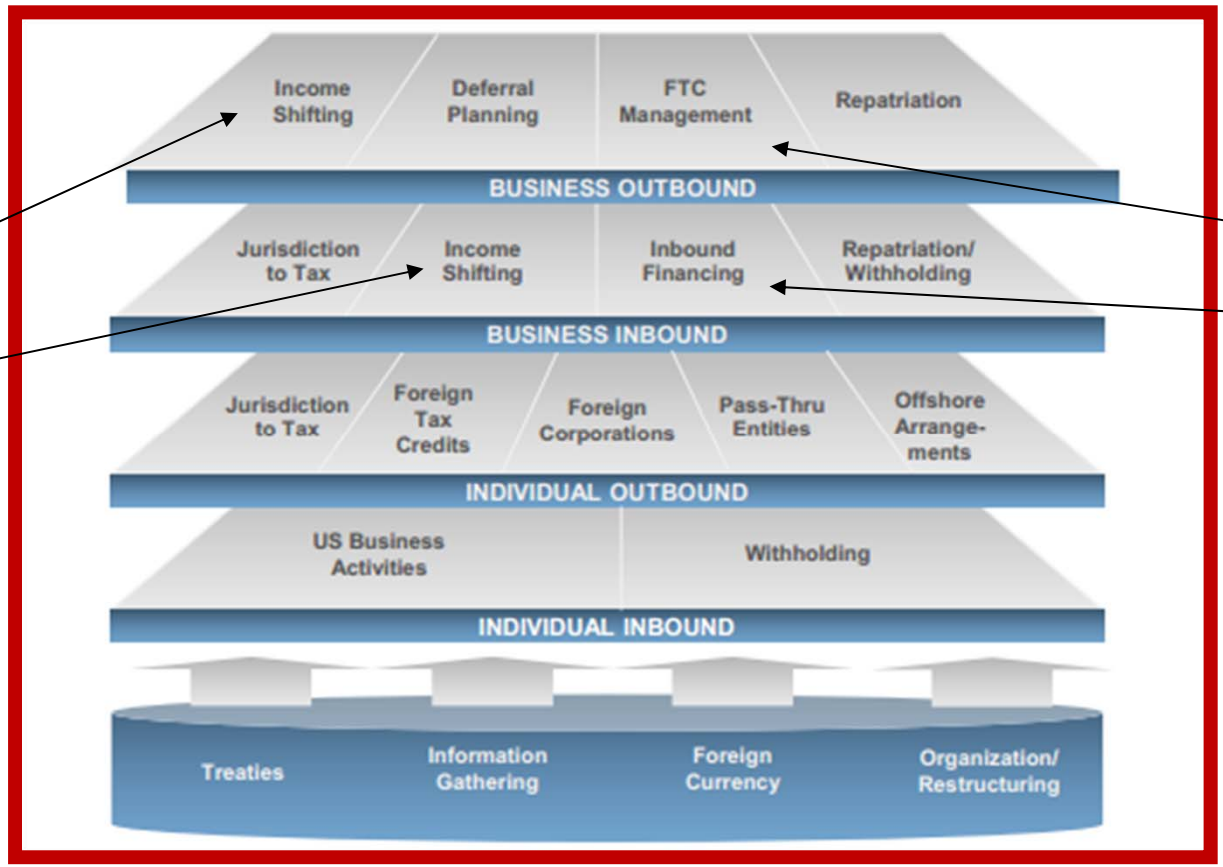
    In every case we audit, we must put forward the best and most current legal positions available on behalf of the United States Government and we must do so consistently across the organization.

    – Heather Maloy (Aug. 17, 2012)

  - Employee communities (networks) with knowledge and insight in particular areas, organized around the "international matrix" (see next page)
    - "Training, not advice"
    - Wollman coordinates along with IPN senior teams (steering committees)
  - **International practice service (IPS)**
    - Repository – library of collective knowledge to serve as resource for international examiner / agent; working on offerings in diverse subject matters and issues; Danilack expects this will become public (FOIA or otherwise)
    - Positions previously asserted unsuccessfully?
  - Agent still the decision-maker

International Matrix

Key Areas for Transfer Pricing



Transfer Pricing may have Relevance

Each section is essentially an IPN (see next page)

IPN Grid

International Practice Networks (IPNs)				
Business Outbound	Business Inbound	Individual Outbound	Individual Inbound	Crossover Areas
Income Shifting Outbound	Jurisdiction to Tax	Jurisdiction to Tax	U.S. Business Activities	Treaties
Deferral Planning	Income Shifting Inbound	Offshore Arrangements	Withholding	Foreign Currency
FTC Management	Inbound Financing	Foreign Tax Credits		Information Gathering
Repatriation	Repatriation / Withholding	Foreign Entities		Organizations / Restructuring

Transfer Pricing Audit Roadmap

- Issued February 14, 2014
- Built around 24 month audit timeline with prior pre-work
- Echoes familiar themes we have been hearing from TPO
  - "Cases are usually won and lost on the facts"
  - "Hypothesis"
- Early and ongoing involvement of TPP and Field Counsel
- Early engagement – Initial meetings
  - Financial
  - TP overview
- Three phases built on IRS QEP model
  - *Planning phase*: (i) Review return including 5471/5472s, UTP; (ii) review 10-K and other publicly available information; (iii) review 6662 documentation; (iv) opening conference (starts 24 month clock) and "orientation" conferences (financial systems and transfer pricing overview)
    - Concludes with initial risk analysis and audit plan
    - TPP involvement from the outset (can range from advisor to lead examiner); also Field Counsel
  - *Execution phase* (fact-finding): IDRs, interviews, site visits, plant tours – 14 months
    - Concludes with draft NOPA and consideration of penalties
  - *Resolution phase* (7 months)
    - Issue presentation: Present draft NOPA to taxpayer for discussion prior to finalizing
    - Issue resolution: Taxpayer discussions leading to final NOPA
    - Case closing / RAR

Transfer Pricing Audit Roadmap (con't)

- Thematic points
  - End-to-end TPP involvement (also Field counsel)
  - Purports to rely on ongoing open communication between Exam and the taxpayer
  - Premium on taxpayer's upfront preparation and readiness to engage leading to TP orientation
  - Focus on building litigation-ready cases
    - Emphasis on cases being "won or lost on the facts"
  - Focus on early "hypothesis" / risk analysis then testing and refining as factual development proceeds

Draft § 482 Rev. Procs.

- **Notice 2013-78 – MAP revenue procedure (will replace RP 2006-54)**
- **Notice 2013-79 – APA revenue procedure (will replace RP 2006-9)**

- **Timing**
  - Draft revenue procedures released November 22, 2013
  - Comments were due by March 10, 2014
  - TPO personnel stating that finalized Rev. Procs. will be issued in second half of 2014 (not effective prior to finalization)
  - There is some call to re-propose, rather than issue in final

- **Drafts reflect changes to IRS structure and creation of single TPO organization**
  - Similar concepts permeate both documents
  - Emphasis on transparency and increased APMA/taxpayer interaction

Draft § 482 Rev. Procs. (con't)

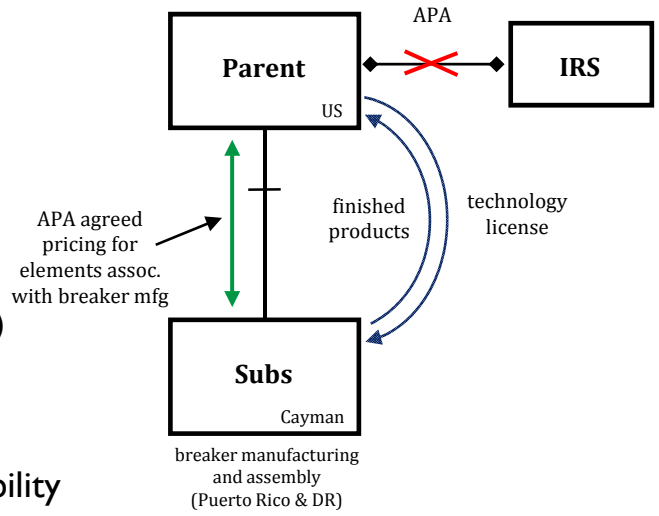
- **Notice 2013-78 – MAP**
  - Confirms that MAP issues may arise due to taxpayer-initiated positions, although a denial of assistance may occur if the request suggests after-the-fact tax planning or fiscal evasion
  - Increased CA involvement in Exam proceedings (e.g., CA involvement in settlement of §482 issues that are likely to involve a treaty partner so as to maintain strength in bilateral negotiations)
  - Increased use of ACAP (filed years) and referrals to APMA (non-filed years) for overall resolution
  - Heightened filing requirements, including requirement for pre-filing memorandum for certain categories of CA requests (e.g., income adjustments > $10M, cases involving intangibles or global dealing)
  - Encourages wider use of SAP (Simultaneous Appeals Procedure)
- **Notice 2013-79 – APA**
  - Taxpayer initiated adjustments may be rolled back to pre-APA open years
  - Increased use of APA rollbacks (APMA can condition acceptance into the program on taxpayer agreement to rollback, or otherwise pursue rollback *sua sponte* after giving notice to taxpayer)
  - Unilateral APAs further discouraged
  - Requirements to provide same information to both CAs in bilateral context
  - Specific application filing requirements set forth in Appendix
  - Includes abbreviated APA renewal opportunity

TP Cases of Interest

The Eaton APA Saga

- **Background**
  - Eaton is globally-diversified industrial manufacturer (formerly US MNE, now inverted)
  - **1994** – Eaton acquired Westinghouse's distribution / control business (incl. 4 mfg plants in PR and assembly plant in DR, generally owned by Cayman entities)
    - Only customer is a US affiliate (transfers 50% to other affiliates for use as components in other products; the excess sold to OEMs and to 3rd party distributors)
  - **2004** – IRS / Eaton execute initial unilateral APA for 2001-05; in that APA: *US affiliate* was tested party, breaker line segregated from US affiliate's other lines, and a 2-step TP method established (should allow US affiliate to earn at least 20% profit on operating expenses)
  - **Dec. 2006** – IRS / Eaton signs renewal APA for 2006-10; note that in May 2006, an IRS economist wrote memo to APA renewal team questioning, e.g., Cayman subs' profitability

Simplified Overview



  - **Dec. 2011** – IRS economist (Hatch) tenders TP study showing Cayman subs' profits off the charts, and the next day (1) Int'l Specialist TP report (relying on Hatch) questions taxpayer's functional analysis (and concludes *Cayman entities* should be tested party), and (2) IRS notifies taxpayer of intention to retroactively revoke the two APAs

The Eaton APA Saga (cont.)

- **Background (cont.)**
  - **Dec. 2011 (cont.) –** APA revocation (based on misrepresentations and violations of APAs) resulted in IRS making TP adjustments totaling approx. $370m resulting in $75m tax deficiency and $52m in penalties (Notice of Deficiency issued Dec. 19, 2011)
  - **Feb. 2012** – Eaton petitions Tax Court challenging cancellation and subsequent income adjustment (Eaton strongly disagrees with Hatch's analysis); argues that APAs are enforceable contracts and thus IRS must show entitled to cancel under contract law
    - First case where taxpayer challenged IRS exercise of discretion to cancel an APA
    - IRS contends Rev. Procs. under which APAs granted reserve certain discretion to IRS and thus cancellations are *administrative decisions* and must be sustained unless demonstrate *abuse of discretion*
  - **June 2013** – Tax Court agrees w/ IRS on contractual challenge (140 TC No. 18); court will separately review cancellations under *abuse of discretion* standard (taxpayer must prove that cancellation was *arbitrary, capricious or without sound basis in law or fact*); Docket No. 5576-12
  - **August 2013** – IRS asks court to bifurcate remaining issues so that can first address whether IRS acted properly in cancelling APAs before getting to issue of TP adjustments; IRS believes that negotiated settlement unlikely if issues are tried together
  - **December 2013** – Eaton files memo in support of its 2nd motion for partial SJ that notice of deficiency *arbitrary/capricious*; criticizes Hatch work – lack of care; clearly flawed; *Veritas*

Eaton APAs – 2014 Update

- **2014 – status of positions / updates**
  - Eaton has long argued that IRS must explain its rationale for cancellations
    - Eaton argues that IRS must release 4 internal memos associated it claims will shed light on the APA cancellations (and thus are relevant to Eaton's case); IRS has refused to provide the memos on the ground of attorney work product and executive privilege; Eaton has also asked to depose Steve Musher (ACCI) to gain insight into cancellations
    - Tax Court initially denied Eaton's motion to compel, but upon reconsideration Judge Kroupa ordered IRS to explain its rationale, noting that Eaton "has a substantial need to understand respondent's justifications"
    - IRS provided Eaton APA cancellation justification in early April 2014 (via discovery), but did not submit explanation as exhibit (apparently due to Eaton threat of "unspecified sanctions"); subsequently asked Tax Court to excuse Musher from depositions
    - Early May 2014 – IRS officially filed APA cancellation justification with its first supplement to its motion to amend the order (e.g., re potential Musher deposition); Eaton responded (1) including a declaration of a former employee denying IRS assertions that he said Eaton company policy was to intentionally violate APAs, (2) arguing that IRS waived privilege to the 4 memos, and (3) describing the IRS allegations leading to cancellation as "outrageous," without basis (thus more discovery needed)
  - **May 12, 2014** – most-recent Tax Court hearing
    - Judge Kroupa suggests Eaton may depose Musher (but Eaton wants the 4 internal memos)
    - Eaton acknowledged discrepancies between 2005-06 TPs per APAs and that reported on returns, but called them mistakes later discovered/corrected via amended annual APA reports and tax returns; IRS argues that *undisputed fact that Eaton misstated its TP justified cancelling APAs* (IRS said errors were not mistakes but deliberate, resulting in shifting profits from US to Cayman), as well as failure to flag book-tax differences in annual APA reports, defeats Eaton's abuse of discretion argument

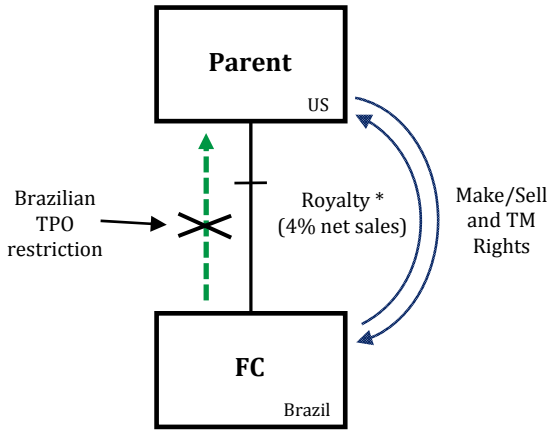
Reflecting on Eaton

- **In light of new APMA structure, query impact of *Eaton* on taxpayer willingness to pursue APAs**
  - APMA structure may suggest an administrative preference to expand possibility for APAs, and seemingly positive reflection on point that during APA Program's first 20 years over 1,000 APAs were executed and only 11 cancelled / revoked (including the two at issue in Eaton); however, restructuring the APA Program under TPO may increase possibility that IRS may take action similar to that in Eaton
  - APAs are intended to avoid TP disputes over highly factual issues and to conserve resources; will "Eaton" uncertainty be factored into decision re whether APA remains viable possibility?
    - "Abuse of discretion" standard sets high hurdle for taxpayer
- **What specifically drives the IRS to cancel APAs?**
  - IRS has long has had ability to undo APA for a number of reasons (e.g., misrepresentation, failure to state material fact, failure to establish good faith compliance with terms / conditions)
    - June 2013 decision – Tax Court noted that IRS cancelled APAs after concluding that Eaton "had not complied with the terms and conditions of the APAs at issue. (It is unclear from the limited record the specific terms with which [the IRS] alleges [Eaton] failed to comply.)"
    - April / May 2014 filing – IRS indicates Eaton intentionally deviated from APA terms and took deliberate steps to deceive IRS (discrepancies b/t TP reported on APA annual reports and tax returns, failure to flag book-tax differences; internal ledger problems; Sept. 2011 former tax manager said "intentional deviation" from APAs, etc.); Eaton says mere data errors, suggests substantial compliance
  - IRS had concerns re Cayman profits and tested party identity in 2006 – why did it then renew the APAs?

3M's Tax Court Case

- ***3M Company v. CIR* – petition filed March 2013**
  - US Parent issued licenses to its Brazilian subsidiary to produce/market products in Brazil – 4% royalty
  - The license agreements (which covered a variety of rights) were submitted to the Brazilian PTO for approval, but were rejected
  - License agreements were reworked, and BPTO approved 1% royalty on TMs and taxpayer concluded that Brazilian law prohibited remittances abroad for other rights
  - IRS concluded that Brazilian law was not to be taken into account in computing the arm's length royalty, so made TP adjustment allocating more than $20m in add'l royalty to US Parent – triggering >$4m tax deficiency
    - IRS asserted that *blocked income* regs not satisfied
    - IRS used 6% royalty rate for arrangement, but with offset for unreimbursed R&D expenses
  - Taxpayer's petition challenges the IRS regulatory approach

Simplified Overview



* Original license(s) had to be modified to meet certain Brazilian TPO legal rqmts (as modified has 1% TM royalty)

Blocked Income

- **Background**
  - In 1994, the IRS issued regulations that say that the IRS can reallocate income between affiliates *even though* foreign law *prohibits* the payment / receipt of the subject item
  - Treas. Reg. § 1.482-1(h)(2)(i) provides that the IRS:

    > *will take into account the effect of a foreign legal restriction (whether temporary or permanent in nature) to the extent that such restriction affects the results of transactions at arm's length*

    - Four requirements – restrictions taken into account only if / to extent:
      1) Public and generally applicable (not part of taxpayer-government transaction)
      2) Exhaustion of all remedies prescribed by foreign law/practice (unless pointless)
      3) The restriction expressly prevented payment or receipt
      4) Parties have not violated restriction or effectively circumvented it
    - Proof – restriction taken into account only to extent taxpayer either (a) demonstrates that the restriction similarly affected uncontrolled parties, or (b) elects the *deferred income method* of accounting
  - Prior to issuing the present regulations, the IRS had lost on the issue several times in court

3M Points

- In ***First Security Bank*** (1972), Supreme Court held IRS exceeded its authority under section 482 in allocating income to a taxpayer who was legally prohibited from receiving that type of income.
- When the IRS issued regulations on foreign legal restrictions in 1994, the preambles made no reference to ***First Security Bank***.
- Under Supreme Court's 1983 ***State Farm*** decision, the IRS's failure to explain how it believed these regulations were consistent with ***First Security Bank*** would be a basis for holding regulations invalid under the Administrative Procedure Act's arbitrary and capricious standard.
- Under Supreme Court's 2005 ***Brand X*** decision, the regulations may be invalid if the ***First Security Bank*** holding was the Court's view as to the only permissible reading of section 482; answer is probably yes.
- If ***First Security Bank*** holding was Court's view of the only permissible reading of section 482, are the requirements in the regulations for the IRS to give effect to foreign legal restrictions consistent with that holding? Answer to that question is probably no.

Intersport Fashions – 103 Fed. Cl. 396

- ***Intersport Fashions West v. CIR* – February 2012 decision**

  - Foreign Parent acquired US Sub in 1999 and shortly thereafter run into financial difficulty; in 2003 Parent went into bankruptcy and US Sub was sold
  - On its 2001-03 tax years, US Sub claimed deductions based on intercompany arrangements with Parent
    - 2001 – paid $40k insurance charge
    - 2002 – paid $525k management fee
    - 2003 – claimed various "fees" (its allocable share of Parent's restructuring costs)

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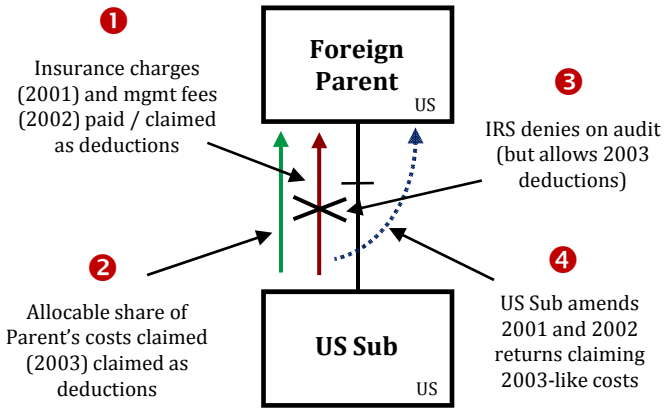

- In 2005, IRS audited 2001-03 tax years; prior to audit CFO told exam team that US Sub planned to amend 2001-02 returns, but examiner requested that he wait until after audit; CFO prepared memo to file on amendments and gave to examiners at beginning of audit
  - IRS made assessments for 2001 and 2002, *but not for 2003*
- Shortly after assessments, US Sub filed amended returns claiming $1.3m (2001) and $1.6m (2002) expenses for allocable share of Parent's costs; but these expense allocations no longer included original "insurance charge" or "management fee"
  - IRS disallowed deductions as prohibited under Reg. § 1.482-1(a)(3) because not timely

Taxpayer-Initiated Adjustments

- **Taxpayer vs. IRS initiated TP adjustments**
  - Taxpayers may affirmatively record transactions at prices different than charged (i.e., to reflect proper pricing) *only if made* (1) prior to filing a timely US tax return, or (2) at any time when the impact is an increase in taxable income (One-Way Street)
  - IRS essentially free to make TP adjustments at any time (Two-Way Street)
  - For both, Rev. Proc. 99-32 is available at taxpayer's election to allow *secondary* adjustments to occur without tax consequences otherwise arising in conforming accounts
- **Interest developing in broadening *taxpayer-initiated* adjustment powers**
  - In *Intersport*, taxpayer argued that it had reported the controlled transaction on its timely-filed original return but had made a *mistake* in calculating the allocations/amount (management fee), that it substantially complied with reporting requirement, and that it is permitted to correct mistakes on amended returns – would further § 482 policies (since allocations permitted on its original 2003 return)
  - Court said that the regs are clear that taxpayer cannot affirmatively adjust TP in way that reduces TI on untimely/amended return
  - Significant justification is "clerical" errors

BMC Software – 141 TC No. 5

- ***BMC Software v. CIR* – September 2013 decision**
  - US Parent had two cost-sharing arrangements with sub (Europe Co) for software development, but terminated CSAs in 2002 and acquired all assoc. IP
  - As part of cancellation, established two way license with Europe Co (net positive payments to Parent), with payments from 2002 onward
  - Parent took advantage of 2004 Act § 965 repatriation during its FYE Mar. 31, 2006; Parent certified that it had no increased debt owed to it during § 965 testing period
  - IRS examined 2002-06 returns, increasing Parent's income for each year on basis that royalties not arm's-length (IRS reduced payments to Europe Co); in 2007, IRS and Parent entered into a closing agreement
  - To conform accounts, Parent elected Rev. Proc. 99-32 (rather than deeming capital contributions) to estab. interest-bearing A/Rs from Europe Co; Parent and IRS entered into second closing agreement in 2007
  - IRS then asserted A/Rs were debt, issued $13m deficiency

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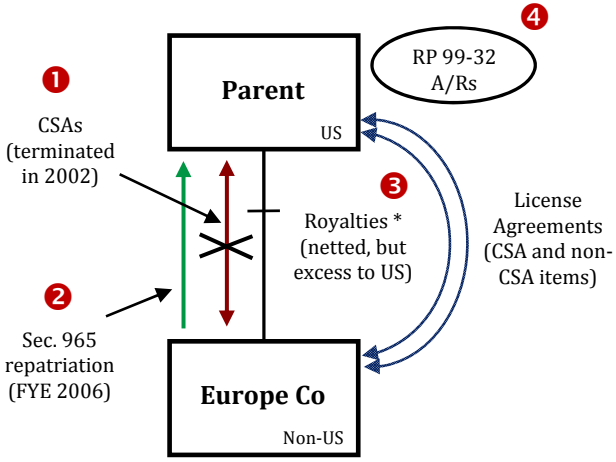

* Parent acquired Europe Co's CSA rights and agreed to pay license fees for period, while Europe Co licensed technology from Parent for distribution

BMC Software (cont.)

- **Relevant provisions**
  - **Rev. Proc. 99-32** – Taxpayers can elect to conform accounts, in connection with primary TP adjustments, in way that avoids natural/default tax consequences of such secondary adjustments
  - **§ 965** – AJCA 2004 provided one time 85% DRD for cash repatriation of foreign profits; several limits including (a) all covered repatriations must occur within one fiscal year, and (b) cutback on allowance based on any *increase in CFC's related party debt over the testing window*
    - Some Rev. Proc. A/Rs arguably were established during testing period
    - Notice 2005-64 (Aug. 19, 2005) § 10.06 provides "Accounts payable established under [RP 99-32], in connection with section 482 adjustments are treated as indebtedness for purpose of 965(b)(3)" (petitioner repatriated funds 6/29/05 through 3/31/06)
- **Case is really a lesson on audits and closing agreements (in TP world, and generally)**
  - IRS / taxpayer entered into A/R closing agreement agreeing repayment of A/R free from further US income tax consequences
- **§ 956 implications**
  - Court did not mention Notice 2005-64 cite, making "debt" analysis more troubling; is holding not limited to § 965?

Amazon's Tax Court Case

- ***Amazon.com Inc. v. CIR* – petition filed December 2012**
  - *Veritas* redux – taxpayer established qualified cost sharing arrangement (CSA) in 2005 to develop IP for websites; as part of that process, Deloitte determined that FC should pay $217m as of Jan. 1, 2005 for pre-existing IP
    - FC was to make buy-in over 7 years, with 2005 payment of $73m and 2006 payment of $83m; IRS started auditing CSA in July 2008 and engaged economists to issue report (issued Jan. 2011) which determined FC should have paid $3.6b as of Jan. 1, 2005.
    - IRS issued NOPA in May 2011 increasing buy-in payments for 2005 and 2006 by $1b and $1.2b, respectively.
    - IRS valuation used a similar approach to Deloitte (e.g., valued intangibles on aggregate basis rather than separately valuing items of IP, used same projections), but did, e.g., use *DCF valuation* and valued pre-existing intangibles into perpetuity rather than over some useful life (e.g., 7 years). Also dispute whether entire line of business was transferred (vs. pre-existing intangibles.)
    - Case was designated for litigation
  - Limited impact on buy-ins b/c 2009 CSA regs? But maybe impact on IP valuation generally?

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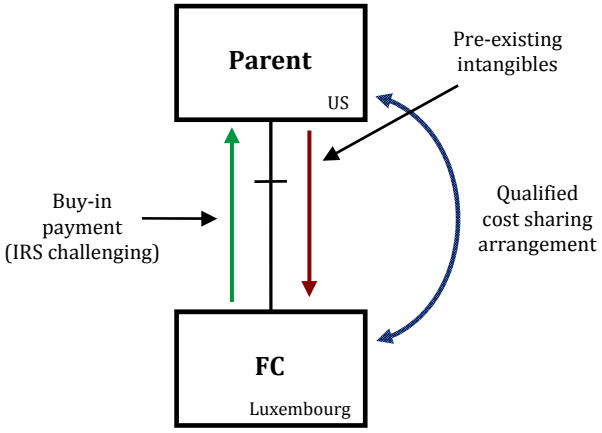

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