IVINS, PHILLIPS & BARKER
CHARTERED

U.S. Transfer Pricing Developments

Litigation Update and Other Developments

J. Brian Davis

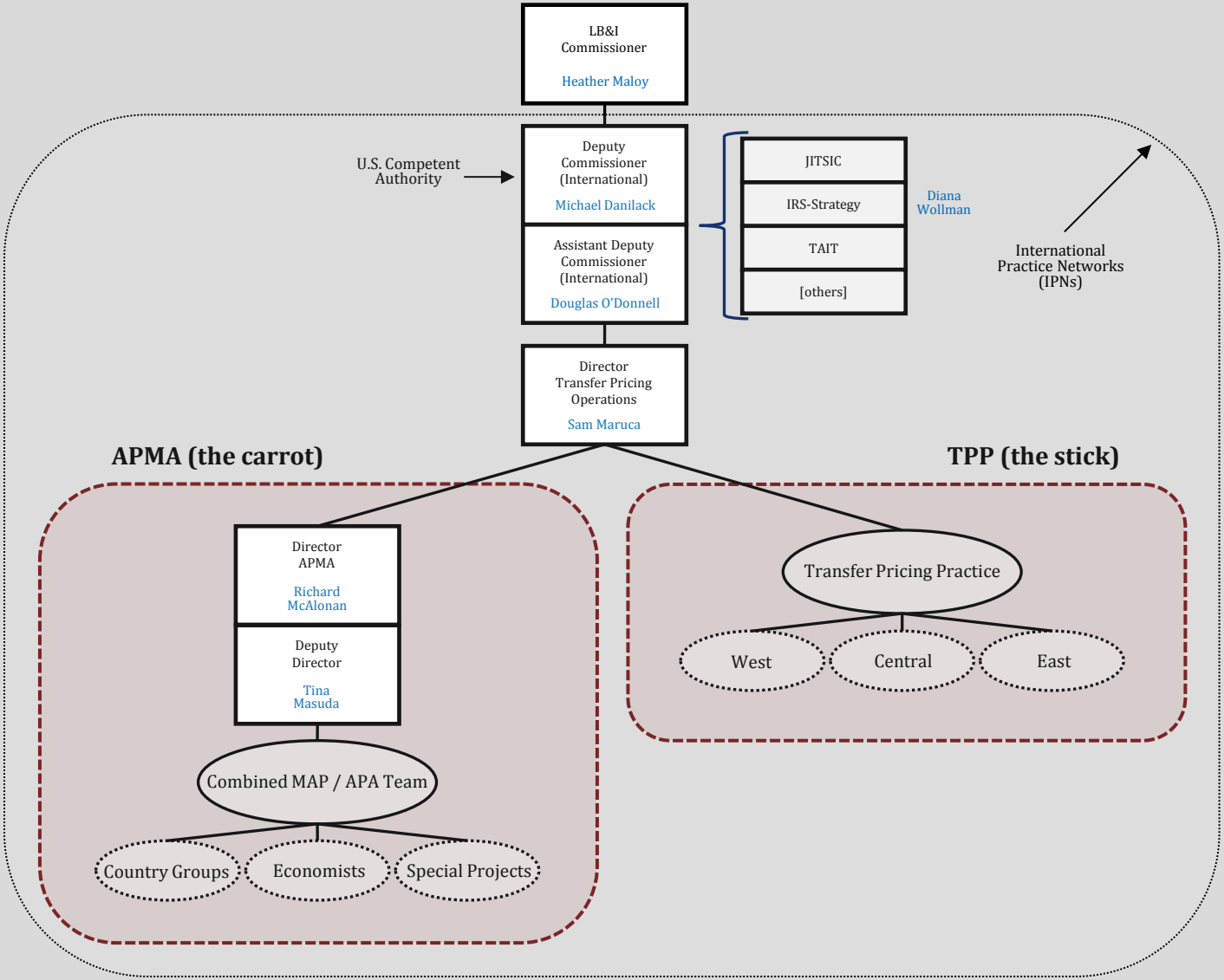
Bloomberg BNA – New York City
Advanced U.S. Transfer Pricing
5 December 2013

Agenda

- **Administrative update**
  - The reorganized IRS
  - US-India update
  - Proposed MAP and APA revenue procedures
- **Transfer pricing cases of interest**
  - Eaton
  - 3M
  - Intersport Fashions West
  - BMC Software
  - Altera
  - 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**
- **International practice networks (IPNs)**
  - Working on knowledge management offerings in diverse subject matters / issues, to serve as resource for international agent
  - Individual topics should be ready to go in early 2014, and Danilack expects a FOIA request
  - Positions unsuccessfully asserted previously?
  - New Director of International Strategy will be helping coordinate along with senior team
  - Agent still the decision maker

U.S.-India Relationship

Background

- India tax positions have become increasingly aggressive from OECD-based FDI investor's perspective (see *Vodafone*, shrink-wrapped software, etc.)
  - Long road to resolution – "if you're in India, you're in court"
- Communication breakdown between Indian and US CAs (early 2010)
- *Vodafone* and retrospective legislation overruling Indian SC (early 2012)
- India started APA program, surprisingly low early turnout (summer 2012)
- US CA expresses belief that Indian authorities are too aggressive, he lacks confidence that US could reach an agreement on bilateral APAs with India, that U.S. taxpayers should talk to the IRS before completing APA filings with the Indian authorities / FTC concerns (summer-autumn 2012)

Irreconcilable differences?

- US CA publicly comments that India's tax examination process is "irrational" – argues it is a problem of unified exam and policy functionality; US trade associations petition CAs asking for resolution (early 2013)
- India / US "fresh starts" – India replaces CA (July 2013); Bob Stack and Mike Danilack visit India (Sept. 2013)
- APAs probably still problematic – Danilack says trip involved "productive and open discussion" with "good engagement and expression on both sides" but not yet "normalized" and trying to work through "principles"

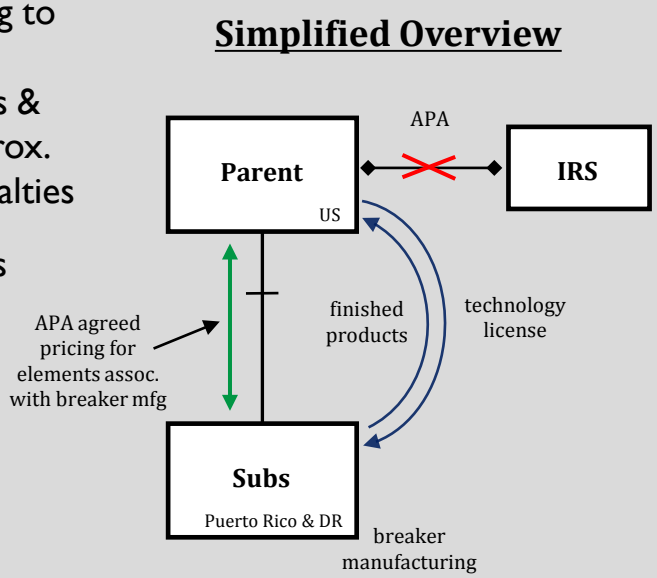
Draft § 482 Rev. Procs.

- **New draft revenue procedures released (22 November 2013)**
  - Goal is to be (a) accommodating, (b) transparent, and (c) consultative, esp. due to BEPS; the newly reworked RPs should improve clarity and reflect new IRS structure (LB&I, APMA, etc.)
  - Comments requested by 10 March 2014
- **Notice 2013-78 – MAP revenue procedure (will replace RP 2006-54)**
  - Notes 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
  - Informal consult available from APMA and TAIT re compulsory payment issues and exhaustion of remedies (e.g., *Vodafone* scenarios)
  - New streamlined procedure for invoking ACAP without examining office consent
  - Sets forth basic procedures for dealing where tax treaties include mandatory arbitration
- **Notice 2013-79 – APA revenue procedure (will replace RP 2006-9)**
  - Indicates that a protective claim for refund/credit may be included in a bilateral/multilateral APA request
  - Includes abbreviated APA renewal opportunity and protocol for seeking permission to so file

TP Cases of Interest

Eaton Corp. – 140 TC No. 18

- ***Eaton Corp. & Subs. v. CIR* – June 2013 decision**
  - First case where taxpayer challenged IRS exercise of discretion to cancel an APA
  - IRS and taxpayer had entered into unilateral APAs relating to Eaton's manufacturing subs. Around December 2011, IRS retroactively cancelled APAs asserting misrepresentations & violations thereof, and made TP adjustments totaling approx. $370m resulting in $75m tax deficiency and $52m in penalties
    - Eaton challenged cancellation in court, arguing APAs are enforceable contracts and thus IRS must show entitlement to cancel under contract law
    - IRS contended 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*



  - Court agrees with IRS; will separately review cancellations under *abuse of discretion* standard (taxpayer must prove cancellation was *arbitrary, capricious or without sound basis in law or fact*)
  - *Post-ruling events* – in August 2013, IRS asked court to bifurcate remaining issues so that could 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

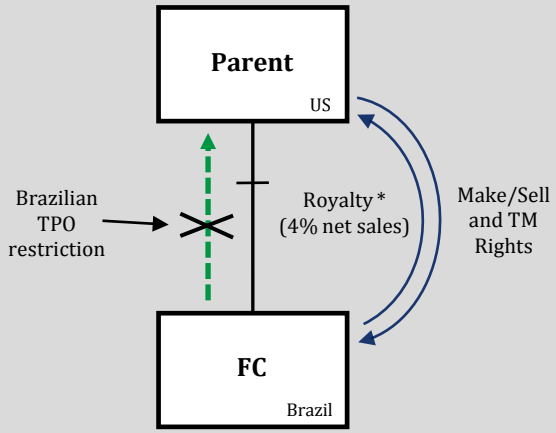
Reflecting on Eaton

- **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; "Eaton" uncertainty should 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)
  - 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.)"
  - Further Eaton proceedings may shed light on what specific facts / actions warrant cancellation

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:

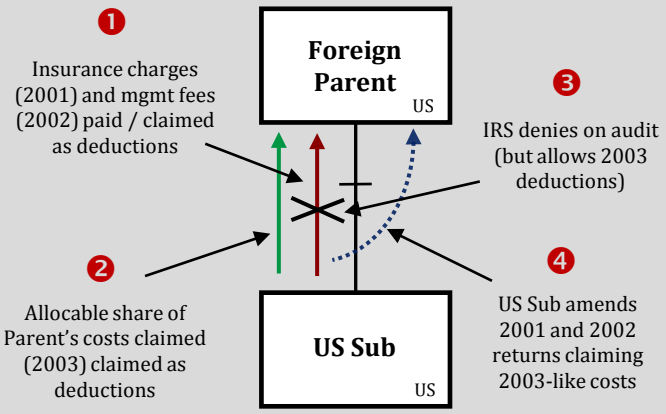
    > *will take into account the effect of a foreign legal restriction (whether temporary or permanent in nature) to the extent that such restriction affects the results of transactions at arm's length*

    - 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

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)

Simplified Overview



- 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

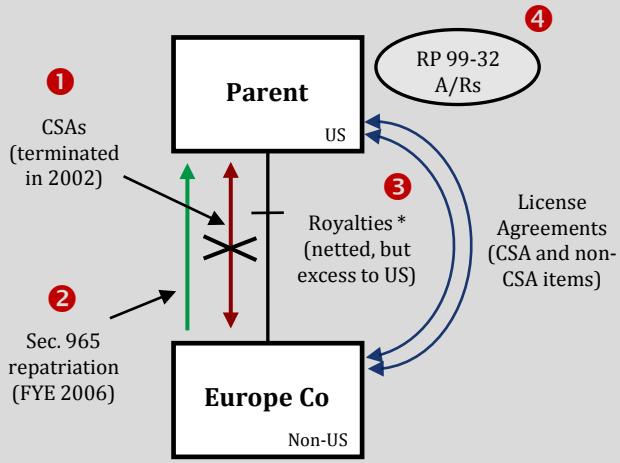
Taxpayer-Initiated Adjustments

- **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) and is permitted to correct mistakes on amended returns – said would further § 482 policies
    - IRS said that the regs are clear that taxpayer cannot affirmatively adjust TP in way that reduces TI on untimely/amended
  - Significant justification is "clerical" errors
  - BEPS-era considerations?

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

Simplified Overview



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

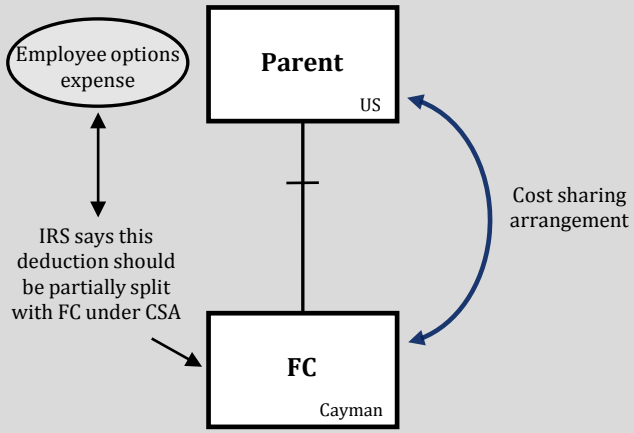
BMC Software (cont.)

- **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 (note: just that, nothing more!)
- **§ 956 implications**
  - Court did not mention Notice 2005-64 cite, making "debt" analysis more troubling; is holding not limited to § 965?

Altera's Tax Court Case

- ***Altera Corp. & Subs. v. CIR* – petition filed April 2012**
  - *Xilinx* redux – IRS is arguing against employee stock-option expense treatment in cost sharing arrangement
    - IRS says 100% in US inappropriate, should split expense with Cayman party in cost sharing arrangement
    - IRS has been making a losing argument here for years, first in *Seagate* (IRS conceded issue) and then again in *Xilinx* (lost in Tax Court and on appeal to 9th Circuit); but note: Xilinx's win was under an older set of regs
  - Taxpayer is arguing that the 2003 regulations (which specifically state that employee stock options costs must be included in CSAs) should be overturned; indicates they are impossible to follow
    - 2011 SCOTUS decision – *Mayo Foundation* – seemingly complicates the case (arguably harder to challenge tax regs)

Simplified Overview

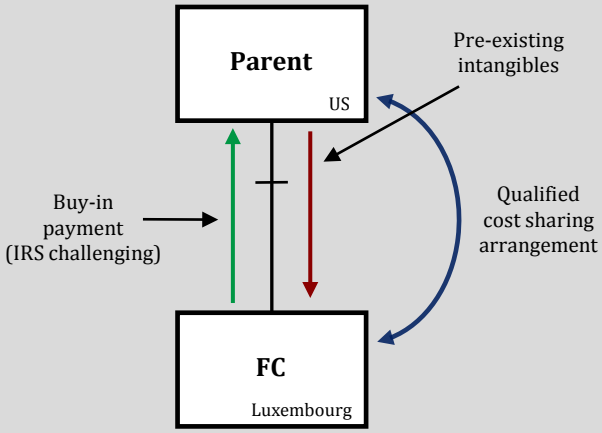


- Public filings indicate that taxpayer expects "to present…legal arguments on other inter-company transactions that are subject to litigation to [court] by the end of 2013"
- Case development unclear – in late September 2013, parties filed joint status report requesting additional time to report further re *penalty issue* and *affirmative adjustment issues*

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; as a result, IRS issued NOPA in May 2011 increasing buy-in payments for 2005 and 2006 by $1b and $1.2b, respectively. IRS valuation used 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

Simplified Overview



- Trial is expected to begin in Nov. 2014, with first stipulation of facts due Dec. 19, 2013
- Limited impact on buy-ins b/c 2009 CSA regs? But maybe impact on IP valuation generally?

Thank you…

J. Brian Davis

BRIAN DAVIS is a partner in the Washington, D.C. office of Ivins, Phillips & Barker. He has practiced in all areas of U.S. federal income taxation, with considerable experience assisting public and private businesses with U.S. and global tax planning matters. He regularly serves as a trusted tax adviser to Fortune 200 companies and high net worth individuals, and has also worked in industry as Director of International Tax for Viacom Inc. Brian is known amongst corporate and tax executives for his technical proficiency and pragmatic approach.

Brian regularly speaks at events sponsored by TEI (where he previously served as a Vice Chair of the International Tax Committee), the International Fiscal Association and the American Bar Association. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

Partner – International Tax
Washington, D.C.

bdavis@ipbtax.com
O: + 1 202 662 3424
M: + 1 202 445 6855

The Firm

IVINS, PHILLIPS & BARKER, founded by two of the original judges on the United States Tax Court in 1935, is the leading law firm in the United States exclusively engaged in the practice of federal income tax, employee benefits and estate and gift tax law. Our decades of focus on the intricacies of the Internal Revenue Code have led numerous Fortune 500 companies, as well as smaller companies, tax exempt organizations, and high net worth individuals to rely on the firm for answers to the most complicated and sophisticated tax planning problems as well as for complex tax litigation. We provide expert counsel in all major areas of tax law, and we offer prompt and efficient attention, whether with respect to the most detailed and intricate of issues or for rapid responses to emergency situations.

Notable Ivins Attorneys and Alumni:

- **Robert B. Stack**, Deputy Assistant Secretary (Int'l Tax Affairs), US Department of the Treasury
- **Danielle E. Rolfes**, International Tax Counsel, US Department of the Treasury
- **Leslie J. Schneider**, treatise author, *Federal Income Taxation of Inventories*
- **Patrick J. Smith**, prolific author and leading practitioner on issues related to challenging administrative rule-making in federal tax context (e.g., IRS regulatory authority)
- **Eric R. Fox**, lead counsel in *United Dominion Industries* (the landmark 2001 US Supreme Court decision re consolidated group loss limitations)
- **Hon. James S.Y. Ivins**, original member of US Board of Tax Appeals (now the US Tax Court) and author of its first reported decision

Representative Clients:

- Amazon.com
- Bayer
- Boeing
- Eaton
- Ford
- General Electric
- Grant Thornton
- H.J. Heinz
- IBM
- Jacobs Engineering
- Lockheed Martin
- Milliken & Company
- NCR
- Red Hat, Inc.
- Sodexo
- Textron, Inc.
- Valero Energy
- Xerox

Washington, D.C.

Los Angeles, CA

www.ipbtax.com

Washington: + 1 202 393 7600

Los Angeles: + 1 310 551 6633

Disclaimer

This presentation, including any attachments, is intended for use by a broader but specified audience. Unauthorized distribution or copying of this presentation, or of any accompanying attachments, is prohibited. This communication has not been written as a formal opinion of counsel. Accordingly, IRS regulations require us to advise you that any tax advice contained herein was not intended or written to be used and cannot be used for the purpose of avoiding federal tax penalties.