32nd Annual TEI-SJSU High Technology Tax Institute

Transfer Pricing

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November 8, 2016
Breakout B

Agenda

1. Aggregation of Transactions – Fred Chilton
2. Control Premium – Matt Kramer
3. The 3M Case – Paul Dau
4. Controversy Update – Sanford Stark
5. RAB Share – Drew Crousore
6. Altera - Drew Crousore
7. After Altera-Treatment of the SBC Reimbursement – Fred Chilton

San Jose State/Silicon Valley TEI

High Tech Tax Institute
November 8, 2016

A Tale of Two Cases

Section 482 Adjustments

1. **Made on the basis of the affiliated group's income or the separate members' income?**
2. **Aggregation or Separate Treatment of Different Controlled Transactions?**

Fred Chilton, KPMG, Silicon Valley

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A Tale of Two Cases

There were two transfer pricing cases decided by the Tax Court in 2016 involving similar types of medical devices. Both cases involved pulse generators (pacemakers, implantable cardiac defibrillators, and cardiac resynchronization devices), but the taxpayers' products did not overlap entirely.

The overlapping legal issue in the two cases is whether transfer pricing adjustments should be made with respect to separate intercompany transactions on a separate or aggregate basis. One case (*Guidant*) allowed the IRS to aggregate separate transactions for purposes of transfer pricing. The other case, (*Medtronic*) required that separate transactions be analyzed separately.

The Tax Court attempts to reconcile the cases by stating that the question of the proper transfer pricing is a "question of fact". However, the principal facts, relating to: corporate structure; intercompany transactions; and products sold by the taxpayers, are very similar in the two cases.

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A Tale of Two Cases
Guidant

Guidant **(146 T.C. No. 5) Filed February 29, 2016) involved two issues: (1) whether transfer pricing should be made to taxable income of the members of an affiliated group according to the separate or combined income of the members; and (2) whether transfer pricing adjustment should be made according to separate intercompany transactions or on an aggregate basis.**

The result in *Guidant* is largely driven by the Tax Court's decision, based on the regulations, not facts, that the IRS could make its section 482 allocation on the basis of the affiliated group's combined income, rather than using the separate income of the various members. (See, the discussion beginning at slide 15.) Having made that decision, it followed that the Court would allow the various section 482 transactions to be aggregated.

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A Tale of Two Cases

Medtronic **(T.C. Memo 2016-112) Filed June 9, 2016) involved only the question of whether transfer pricing adjustments should be made according to separate intercompany transactions or on an aggregate basis.**

Notwithstanding the similarity of the facts in *Medtronic* and *Guidant*, the Medtronic case did not involve the issue of whether the section 482 allocation should be made on the basis of combined income of the affiliated group. When it came to deciding the issue of whether the Service's section 482 allocation could be made on an aggregated basis, the Court concluded, based on the facts, that the income to be allocated would have to be adjusted based on the separate transactions. (See, the discussion beginning at slide 29.)

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Guidant

Facts

Guidant Products

CRM devices included pulse generators (PGs) (e.g., pacemakers, implantable cardiac defibrillators, and cardiac resynchronization devices) and leads.

ES devices included an aortic vascular prosthesis (Ancure) that could be delivered via balloon catheter to treat aortic aneurysms.

VI devices included balloon catheters used in angioplasty procedures, coronary stents and their delivery systems, and guidewires used to direct balloon catheters and stent delivery systems to the area of treatment.

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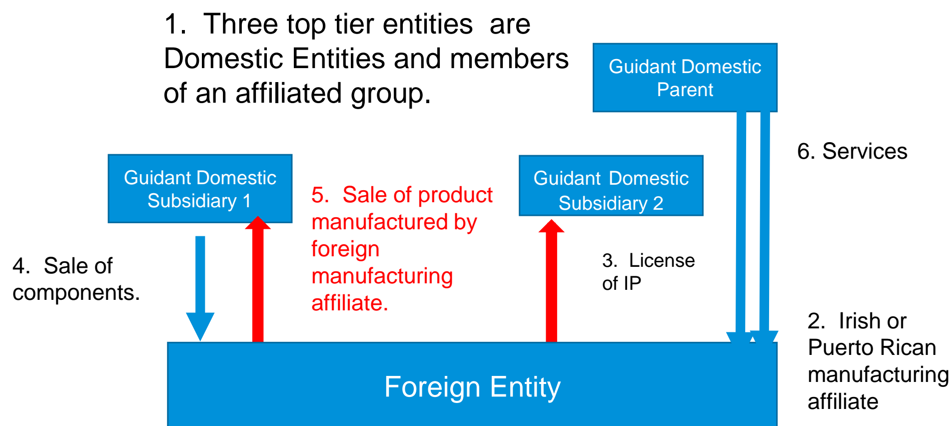
Guidant



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Guidant

The Service's Section 482 Allocation of Income

The IRS determined for purposes of ascertaining the Guidant group's consolidated taxable income (CTI) that all of the adjusted income was the separate taxable income (STI) of Guidant Corp. Respondent did not determine that any of the adjusted income was the STI of one or more of the Guidant group's U.S. subsidiaries. Respondent also did not determine the specific amount of the adjustments that related to tangibles, to intangibles, or to services.

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Medtronic

Facts

Medtronic Products

The type of product involved in Medtronic were primarily CRM devices included pulse generators (PGs) (e.g., pacemakers, implantable cardiac defibrillators, and cardiac resynchronization devices) and leads.

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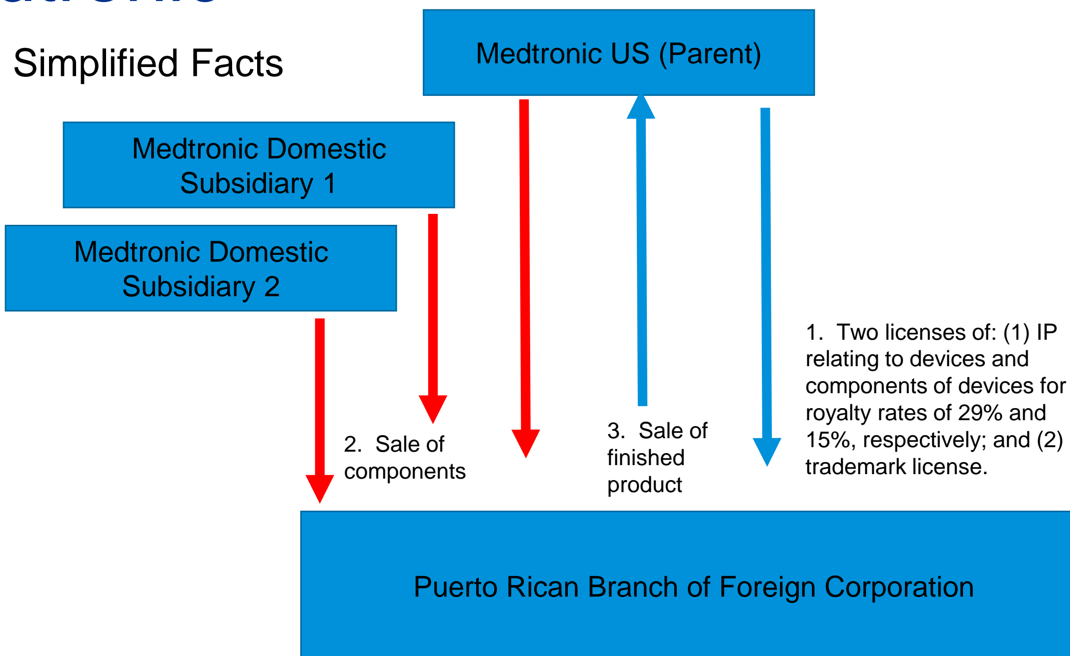
Medtronic



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Medtronic

Facts

The statement of facts in Medtronics is much more detailed than the facts in Guidant relating to: (1) FDA classification of medical devices and the regulatory environment relating to the taxpayer's products; (2) the importance of maintaining qualify control because of the nature of the products (implantable cardiac devices) and taxpayer's efforts to maintain quality control; (3) the nature of the foreign subsidiary's Puerto Rican manufacturing operations; (4) R&D and sales activities; and (5) the nature of the devices.

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Relevant Regulations – Only Guidant

Made to Income of Affiliated Group or the Separate Members?

Treas. Reg. § 1.482- 1(f)(1)(iv), Income Tax Regs provides:

Consolidated returns.--Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

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Relevant Regulations-For Both Cases

Separate or Aggregate Treatment of Individual Transactions

Treas. Reg. § 1.482-1(b)(2)(ii). Selection of category of method applicable to transaction.-- The methods listed in § 1.482-2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result.

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Relevant Regulations-For Both Cases

Separate or Aggregate Treatment of Individual Transactions

Treas. Reg. § 482-1(f)(2)(i). Aggregation of transactions.--(A) In general.--The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in § 1.6038A-3(c)(7)(vii).

Treas. Reg. § 1.6038A-3(c)(7)(vii) provides: Related products or services. The term related products or services means groupings of products and types of services that reflect reasonable accounting, marketing, or other business practices within the industries in which the related party group operates.

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Guidant

IRS Consolidated and Aggregated Adjustments

The Service's Arguments. The Service argued that it should be able to make section 482 adjustments: (1) to the affiliated income of the Guidant group (by an adjustment of income to the group's parent); and (2) to the income from the aggregated transactions, rather than the separate transactions.

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Guidant

Taxpayer's "Hurdles" to have the Court Reject the Service's Section 482 Adjustments

The Commissioner's authority to adjust items under section 482 is broad, and whether the Commissioner has inappropriately allocated items under section 482 is usually a question of fact. See Eli Lilly & Co. v. Commissioner, 856 F.2d at 860; Bausch & Lomb, Inc. v. Commissioner, 92 T.C. at 581-582. Taxpayers which ask the Court to reject the Commissioner's section 482 allocations in favor of the taxpayers' allocations must clear two hurdles in order to prevail. First, a taxpayer must establish that the Commissioner abused his discretion by making allocations that are arbitrary, capricious, and unreasonable. See Eli Lilly & Co. v. Commissioner, 856 F.2d at 860; Sundstrand Corp. v. Commissioner, 96 T.C. 226, 353 (1991). Second, a taxpayer must establish that arm's-length consideration for the adjusted transactions is consistent with the taxpayer's allocations. See Sundstrand Corp. v. Commissioner, 96 T.C. at 354.

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Guidant

The Parties Arguments

1. Section 482 adjustment made on the basis of the affiliated group.

Taxpayer's Argument. The IRS abused its discretion because it failed to determine the true separate taxable income (STI) of each controlled taxpayer that engaged in the adjusted transactions. Petitioners note that respondent applied its section 482 adjustments solely to the domestic parent corporation and observed that the parent corporation did not participate in most of the adjusted transactions.

IRS' Argument. The IRS need not determine each controlled taxpayer's true STI whenever the Commissioner makes a section 482 adjustment in the setting of a consolidated return. In such a setting, the IRS must only determine the affiliated group's true combined taxable income.

2. Adjustments made on separate transaction or aggregate basis.

Taxpayer's Argument. Section 482 adjustments must be made with respect to each transaction involving an intangibles license, a purchase and sale of tangible property, or a provision of services. The IRS adjustments were inappropriately made through a combined groupwide analysis on the basis of multiple types of controlled transactions among multiple corporations.

IRS' Argument. Commissioner may aggregate transactions of different types for purposes of effecting a reliable section 482 adjustment.

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Guidant

Section 482 adjustment made on the basis of the affiliated group or the separate members?

Treas. Reg. Section 1.482- 1(f)(1)(iv), Income Tax Regs provides:

Consolidated returns.--Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined.

If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

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Section 482 adjustment made on the basis of the affiliated group or the separate members?

THE COURT'S REASONING

The regulation distinguishes between a controlled taxpayer who files a separate return and a controlled taxpayer who is a party to a consolidated return. In the former case, the regulation states that the taxpayer's STI "will be determined". In the case [of a consolidated return], the regulation lacks the same words, stating instead that the taxpayer's STI and the group's CTI "must be determined consistently with the principles of a consolidated return".

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Guidant

Section 482 adjustment made on the basis of the affiliated group or the separate members?

The Court's Reasoning Regarding the "Principles of a Consolidated Return".

The words "consistently with the principles of a consolidated return" in section 1.482-1(f)(1)(iv), Income Tax Regs.

Petitioner argument. This wording mandates that the IRS should have determined the STI of the individual Guidant group members at the time of making section 482 adjustment to the group's CTI. This interpretation is in line with the consolidated return regime, which requires that "consolidated taxable income is computed by first taking into account the separate taxable income of each member of the group." Applied Research Assocs., Inc. v. Commissioner, 143 T.C. 310, 315 (2014); see also sec. 1.1502-11, Income Tax Regs.

The IRS' Argument. We construe the words "consistently with the principles of a consolidated return" with the assistance of longstanding Supreme Court precedent and of contemporaneous legislative history revealing the intent of the consolidated return regime.

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Section 482 adjustment made on the basis of the affiliated group or the separate members?

THE COURT's REASONING.

Four score and three years ago, the U.S. Supreme Court stated in the setting of two corporations desiring to file a consolidated return that "[t]he requirement of consolidated returns was 'based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation.'" Atl. CityElec. Co. v. Commissioner, 288 U.S. 152, 154 (1933) (quoting Regs. 45, art. 631).

The Supreme Court's statement parallels a statement that the Senate Finance Committee memorialized in its report on (and issued contemporaneously with) the birth of the consolidated return regime. See S. Rept. No. 65-617, (1918), 1939-1 C.B. (Part 2) 123 (stating that the consolidated return regime was adopted with an understanding that the "principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government").

The legislative history and the Supreme Court statement reveal that the primary principle underlying the consolidated return regime is a taxing of the true net income of the consolidated group as a whole. Cf. United Dominion Indus., Inc. v. United States, 532 U.S. 822, 836 (2001) (noting that the sole purpose of STI is that of "an accounting construct devised as an interim step in computing the group's [consolidated] taxable income or * * * [consolidated net operating loss]").

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Section 482 adjustment made on the basis of the affiliated group or the separate members?

THE COURT's REASONING.

The Court stated:

"Bearing the principles of the consolidated return regime in mind, we read section 1.482-1(f)(1)(iv), Income Tax Regs., to require the Commissioner to determine both CTI and STI when making a section 482 adjustment with respect to income reported on a consolidated return, but also giving the Commissioner a certain latitude to decide when the determination of STI becomes necessary. The primary objective of section 482, as we discern from our reading of that section, is to prevent a distortion of income or an evasion of tax on account of controlled transactions that distort the taxable base. As we see it, the Commissioner's main responsibility under the regulation, when read in the light of the statute to which it relates, is to make sure that the section 482 adjustments serve the purposes of the consolidated return regime discussed above, i.e., reflect the consolidated group's true net income clearly and prevent an avoidance of such tax liability."

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Guidant

Section 482 adjustment made on the basis of the affiliated group or the separate members?

The Court Indicated that the Adjustment was Based on the Consolidated Allocation of Income in the Absence of "Reliable Member-Specific Data" and "Taking into Account the Relationship of the Domestic Entities"

The Court stated:

"On the basis of the record before us, which we must construe favorably to respondent as the party opposing the motion for partial summary judgment, respondent's revenue agents concluded that they were unable to make reliable member-specific adjustments on the basis of the available information. The agents reached their conclusion, in part, on the basis of the relationships between the Guidant group members and their foreign affiliates and on the alleged lack of documentation to make reliable adjustments.

Each of petitioners' entities, performed numerous functions on behalf of its business unit and performed functions on behalf of other Guidant-group-related entities, including the foreign entities. In addition, the Guidant group members each owned valuable intangibles relating to the development and manufacture of the products within their business units, and many products were manufactured both by a Guidant group member and by Guidant Ireland or Guidant Puerto Rico."

While the Court stated that it was affirming the IRS adjustment on the basis of the "record before us", there is nothing in the opinion as to what facts supported the adjustment. (The IRS "notices did not calculate or specify what, if any, amount of the section 482 adjustments was attributable to CPI, to ACS, to EVT, to CTS, or to GSC, or to specific types of controlled transactions." Nor does the opinion seem to indicate the transfer pricing method by which the adjustments were made.)

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Those notices did not calculate or specify what, if any, amount of the section 482 adjustments was attributable to CPI, to ACS, to EVT, to CTS, or to GSC, or to specific types of controlled transactions.

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Guidant

Aggregation or Separate Treatment of Different Controlled Transactions

Taxpayer's Argument. The IRS's section 482 adjustments are arbitrary, capricious, and unreasonable because the IRS did not make separate adjustments for each transfer of tangible property, transfer of intangible property, and provision of service.

The Regulation.

Selection of category of method applicable to transaction.-- The methods listed in § 1.482-2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated trans- actions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result.

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Guidant

Aggregation or Separate Treatment of Different Controlled Transactions

Treas. Reg. § 482-1(f)(2)(i). Aggregation of transactions.--(A) In general.--The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in § 1.6038A-3(c)(7)(vii).

Treas. Reg. § 1.6038A-3(c)(7)(vii) provides: Related products or services. The term related products or services means groupings of products and types of services that reflect reasonable accounting, marketing, or other business practices within the industries in which the related party group operates.

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Guidant

Aggregation or Separate Treatment of Different Controlled Transactions

(f) Scope of review.–

Rules relating to determination of true taxable income.-- The following rules must be taken into account in determining the true taxable income of a controlled taxpayer.

(i) Aggregation of transactions.--(A) In general.--The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in § 1.6038A-3(c)(7)(vii).[3]

* * * * * * *

(iv) Product lines and statistical techniques.--The methods described in § 1.482-2 through 1.482-6 are generally stated in terms of individual transactions. However, because a taxpayer may have controlled transactions involving many different products, or many separate transactions involving the same product, it may be impractical to analyze every individual transaction to determine its arm's length price. In such cases, it is permissible to evaluate the arm's length results by applying the appropriate methods to the overall results for product lines or other groupings. In addition, the arm's length results of all related party transactions entered into by a controlled taxpayer may be evaluated by employing sampling and other valid statistical techniques.

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Guidant

Aggregation or Separate Treatment of Different Controlled Transactions

Section 1.482-1(f)(2), Income Tax Regs., lets the Commissioner aggregate two or more separate transactions to the extent that aggregation serves as the most reliable means of determining the arm's length consideration for the transactions. Section 1.482-1(f)(2)(i), Income Tax Regs., adds that the combined effect of two or more transactions may be considered if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's-length consideration for the controlled transactions.

Notwithstanding the strength of the regulations, petitioners argue that the Commissioner may not aggregate separate transactions involving tangibles, intangibles, or services. We disagree.

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Aggregation or Separate Treatment of Different Controlled Transactions

The ability to aggregate transactions involving transfers of tangible property, transfers of intangible property, and provision of services is further confirmed by section 1.482-1(f)(2) (iv), Income Tax Regs., and by section 1.482-1(f)(2)(i)(B), Examples (2). The Commissioner is allowed to "evaluate the arm's length results by applying the appropriate methods to the overall results for product lines or other groupings", because it may be impractical to analyze the arm's-length price of individual transactions. In Example 2, transactions involving tangibles (finished computers), marketing intangibles, and service fees may be aggregated and considered together in determining the arm's-length consideration for the controlled transactions, because these transactions are so interrelated that they are most reliably analyzed on an aggregated basis.

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Medtronic

Overview of the Legal Discussion

The Parties' Positions

The Taxpayer separately priced each of the four covered agreements between and among Medtronic US, MPROC, and Med USA.

The IRS, on the other hand, performed a functional analysis that looked at all four covered agreements together and applied a CPM analysis to the income to be derived from Puerto Rican manufacturing operations. The IRS "belittled" the rule of the Puerto Rican entity and contended that it was a contract manufacturer that was "replaceable". The IRS economist treated the PR manufacturing operation as if it performed routine activities.

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Medtronic

Overview of the Legal Discussion

The Role of Quality of the PR Manufacturing Operation

The Taxpayer argued and the court accepted that the quality of the manufacturing operations was important. Given the nature of the products (implantable devices), qualify in the manufacture of the products was vital. The products had to be safe. The PR manufacturing operation "not only made the finished product; it made sure that the finished product was safe and could be implanted in the human body."

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Medtronic

Overview of the Legal Discussion

Discussion of Comparability

The IRS Position that it could use an aggregated approach to the various intercompany transactions was dependent upon the Service being able to set the income attributable to the Puerto Rican manufacturing operation based the CPM of "comparable" contract manufacturers.

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Overview of the Legal Discussion

The Court's View of the IRS' Comparables

The Tax Court was convinced that the PR manufacturing operation achieved a high level of quality that was unique.

> "MPROC did more than assemble components. MPROC had the responsibility of taking all the third-party suppliers' components and incorporating them into class III medical devices. MPROC uses its systems engineering expertise to design improvements and improve quality. MPROC has a highly skilled workforce. MPROC tests and sterilizes the devices and leads. These products are not inspected again until they are about to be implanted in a patient."

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Medtronic

Overview of the Legal Discussion

AGGREGATION

The Court stated:

The functions at issue in the covered transactions are able to exist independently. The regulations do not require that the transactions be aggregated. See sec. 1.482-1(f)(2)(i)(A), (iv), Income Tax Regs.

The transactions in Example 4 of the cited regulations are similar to the covered transactions at issue here. Like the Example 4 transactions, the covered transactions are accounted for and priced separately in the market. Transactions may be aggregated if an aggregated approach produces the "most reliable means of determining the arm's length consideration for the controlled transactions." Veritas Software Corp. & Subs. v. Commissioner, 133 T.C. at 321; sec. 1.482- 1(f)(2)(i)(A), Income Tax Regs.

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Medtronic

Overview of the Legal Discussion

AGGREGATION

The Court further stated:

Petitioner contends that the transactions should not be aggregated and that aggregation treats MPROC more like a contract manufacturer, failing to take into account its full role. Respondent contends that aggregating the transactions was required. Section 1.482-1(f)(2)(i), Income Tax Regs., states that the combined transactions may be aggregated in certain circumstances. The regulations let the Commissioner aggregate separate transactions involving tangibles, intangibles, or services when doing so provides the best means of determining the true taxable income of a controlled taxpayer. Guidant LLC v. Commissioner 146 T.C. _ , _ (slip op. at 38) (Feb. 29, 2016); see, e.g., sec. 1.482-1(b)(2)(ii), (f)(2)(i), Income [*116] Tax Regs. Thus, whether respondent abused his discretion by aggregating transactions involving intangibles, tangible goods, and provision of services is a question of fact. Guidant LLC v. Commissioner, 146 T.C. at _ (slip op. at 39-40).

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Control Premium Adjustments in Acquisition Platform Contribution Transactions

Matt Kramer

Skadden, Arps, Slate, Meagher & Flom LLP

Control Premium Adjustments in Acquisition PCTs

- General issue
  - The amount paid to acquire a company (the "acquisition price") is often higher than the pre-acquisition fair value of that company (the "acquisition premium")
  - All or a portion of that acquisition premium may be attributable to a control premium
  - Should the value of the PCT payment calculated under the acquisition price method ("APM") be reduced by the amount of the acquisition premium attributable to the control premium?

What Is Control?

- “Control” in this context does not refer to control within the meaning of I.R.C. §482 (“two or more organizations, trades or businesses…owned or controlled directly or indirectly by the same interests”)
- “Control” for purposes of a control premium is defined as the ability to
  - Direct corporate action
  - Select management
  - Decide the amount of distribution
  - Rearrange the corporation’s capital structure
  - Decide whether to liquidate, merge or sell assets.
    - *Philip Morris Inc. v. Comm’r.* 96 T.C. 606 (1991)

What Is Control? (con’t)

- Control is directly tied to the value of a business
  - “The value of a business is determined by decisions of the managers of that business on where to invest its resources, how to fund these investments and how much cash to return to the owners of the business.” Damodaran, *The Value of Control: Implications for Control Premia, Minority Discounts and Voting Share Differentials* (2005)
- Control is distinguishable from synergies
  - Synergies may also be part of the acquisition premium
  - Synergies are typically defined as potential additional value derived from combining two companies
    - Operational synergies (allowing companies to reduce operating costs or increase revenue and growth, or both)
    - Financial synergies (allowing a combined company to realize higher cash flows, lower borrowing costs or more favorable tax status)

Control Premiums in Acquisition PCTs Example

- PCT payment = acquisition price + liabilities – tangible assets – other assets not covered by a PCT

	Without Control Premium	With Control Premium
Acquisition Price	$100,000,000	$100,000,000
Tangible Assets	$10,000,000	$10,000,000
Control Premium	$0	$20,000,000
Intangible Value	$90,000,000	$70,000,000
ROW RAB Share	50%	50%
PCT Payment	$45,000,000	$35,000,000

Control Premium as Arm's Length Behavior

- At arm's length, do parties actually pay a control premium?
  - Eric Nath: No. "mere fact of control does not lead to any specific premium." The premium paid in an acquisition is attributable to the laws of supply and demand. *Best Practices Regarding Control Premiums* (2011)

What is Compensated in a Controlled Transaction?

- All value? Treas. Reg. 1.482-1T(f)(2), example 7
  - P transfers intangible property (computer code, manuals) to S1 for compensation
  - P transfers other items to S1 that are interrelated with the transferred intangibles
    - Not property
    - Not transferrable
    - Do not give rise to income
  - "…even if P's assertion that certain items were either not property or not capable of being transferred were correct, arm's length compensation is nonetheless required for all the value associated with P's contributions under the section 482 regulations"

Control Premium as Payment for Intangibles

- Control exercised by the acquiring company is an intangible asset because it provides value to the acquiring company
- Any benefit to the acquiring company would also benefit the cost sharing participant(s)
  - PCT payment should thus not be adjusted for a control premium

Control Premiums as Arm's Length Behavior

- Weight of authority suggests premiums are paid for control
  - A control premium is the premium paid to induce shareholders to transfer control of the corporation. *Philip Morris*
  - IRS argument in *DHL Corp. v. Comm'r* (T.C. Memo 1998-461) that the overall value of a company should be determined by adding a control premium to the value of underlying intangible assets
  - "It is not uncommon in private company and acquisition valuations to see large premiums attached to estimated value to reflect the 'value of control.'" Aswath Damodaran, *The Value of Control* (2005)

What is Compensated in a PCT?

- A platform contribution is any resource, capability or right (whether self-developed or acquired externally) that is reasonably anticipated to contribute to developing cost shared intangibles. Treas. Reg. §1.482-7(c)(1)
- Federal case law generally defines control as a recognizable right
  - *Philip Morris* (shareholders obtain "the right to control a company" (emphasis added))
- The right to direct corporate action, select management and rearrange corporate structure cannot be reasonably anticipated to contribute to developing intangibles
- Since control is exercised by shareholders of the acquiring company, it is not contributed to the CSA

Control as an Intangible

- Cost shared intangibles are any intangible within the meaning of Treas. Reg. §1.482-4(b) that, at the applicable point in time, the controlled participants intend to develop under the CSA. Treas. Reg. §1.482-7(d)(ii)
  - "Control" is not listed as an intangible under Treas. Reg. §1.482-4(b)
  - *Philip Morris:* the value attributable to control is "over and above the value that is attributable to the corporation's underlying assets"
- Preamble to 2009 temporary cost sharing regulations
  - Treasury and IRS acknowledged taxpayer comments regarding reliability of APM and MCM in light of lack of correlation between stock prices and underlying assets owing to control premiums or economies of scale
  - Control premiums and economies of scale need to be taken into account in a best method analysis
- Preamble to 2011 final regulations
  - With some acquisitions, there may be benefits to the controlled group whose scope extends beyond the development of the cost shared intangibles

Control as an Intangible
Merck

- *Merck & Co. v. U.S.* 24 Cl. Ct. 73 (1991)
  - IRS argued that affiliate structures, pricing mechanism structures, and group-wide planning structures were intangible assets
  - Also argued that "diligent efforts" by Merck management were a compensable service
  - Court rejected those arguments
    - Organizational structure, planning, pricing and the "system of control" exercised by the parent were not intangibles
    - "Diligent efforts" undertaken to increase a subsidiary's sales revenue (including shutting down other plants and providing management to control the subsidiary's actions) were not compensable
    - Such activities were simply part of the corporate form in large scale business operations

Implications

- Are premiums paid for control in arm's length transactions?
  - Even if control premiums do not exist (Nath), an adjustment might be appropriate (no PCT payment for premium attributable to laws of supply and demand)
- Does the definition of "platform contribution" encompass control?
- Is control compensable in a controlled transaction?

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TEI-SJSU High Tech Tax Institute (32nd Annual)

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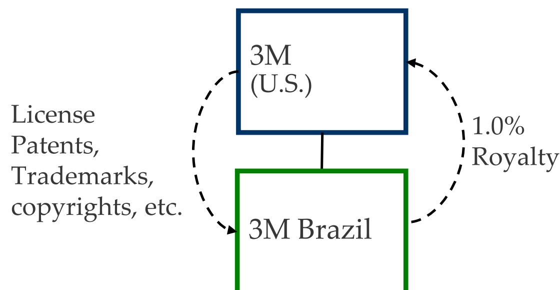
November 8, 2016

3M Co. v. Comr., Tax Court No. 005816-13

- The case addresses the "blocked income" provision stated in Treas. Reg. § 1.482-1(h)(2).
- 3M has challenged the Internal Revenue Service's (IRS's) determination that Brazilian legal restrictions on the payment of royalties from a subsidiary in that country to its US parent should not be taken into account in determining the arm's-length royalty between 3M and its subsidiary.
- The case was submitted fully stipulated under Tax Court Rule 122, and the parties' simultaneous opening briefs were filed on March 21, 2016. Reply briefs were filed June 29 and the IRS filed an amended reply brief on August 18, 2016.
  - On a motion by 3M, the Tax Court ordered oral argument on the validity of the regulation, to be held November 3. The Tax Court had its own agenda, however.

3M Co. v. Comr., Tax Court No. 005816-13



- Brazilian intellectual property law limited royalties to 1%
- IRS applies § 482 to impute $23.6 million additional royalties using 3M standard 6% rate
- IRS applies § 482 relying on Reg. § 1.482-1(h) to eliminate the effects of Brazil's legal restrictions

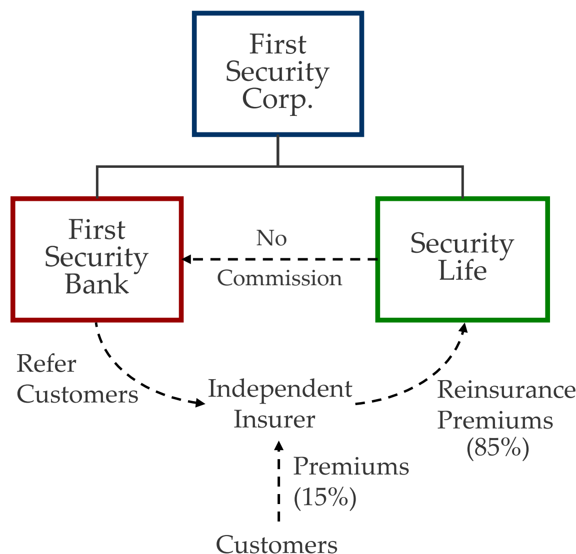
T.R. § 1.482-1(h) Foreign Legal Restrictions

- A foreign legal restriction can be taken into account only if (and for so long as) it meets four requirements:
  - It is publicly promulgated, generally applicable to related and unrelated party transactions, and not imposed in connection with a commercial transaction with a foreign government
  - The taxpayer has exhausted any available remedies to seek a waiver of the restriction
  - The restriction expressly prevents payment or receipt of the income in question
  - The related parties have not circumvented or violated the restriction

Taxpayer Relies on Blocked Income Cases and APA

- Blocked Income cases prevent adjustment
  - *First Security* (Supreme Court) – prohibited receipt (domestic commissions)
  - *Procter & Gamble* (6th Circuit) – prohibited payment (Spanish royalties)
  - *Texaco/Exxon* (5th Circuit) – Saudi directed oil prices
- -1(h) Cannot Override - *Home Concrete* - Supreme Court interpretation of § 482 leaves no room for different IRS interpretation
- APA failures under § § 553 and 706 invalidate reg.

First Security Bank of Utah



- Independent Insurer sold credit default insurance to Bank's customers
- Security Life received 85% of premiums
- Banks were prohibited under Federal law from receiving insurance income
- IRS allocated 40% of Security Life's income to the Bank under § 482 for referral and related services

Government Relies on *Mayo* and Plain Language of Regulations

- In *Mayo Foundation*, 131 S.Ct. 1836 (2011) a unanimous Supreme Court held that *Chevron* deference applies to all Treasury Regulations
  - As a result, if a tax statute does not directly address "the precise question at issue," a court may disturb a regulation only if it is "arbitrary or capricious".
- *Mayo* precludes application of the *National Muffler* test to tax regulations
  - As a result, *it is irrelevant* whether a regulation was promulgated after an adverse judicial decision
- Section 482 clearly does not address the question at issue here and Treas. Reg. § 1.482-1(h) is manifestly neither arbitrary nor capricious

Implications of 3M

- What is the IRS's authority to dictate the meaning of the arm's length standard in light of *Chevron* and *Mayo*?
- What limitations does the APA impose on regulatory rulemaking in the tax context
- What is the significance of prior Supreme Court decisions interpreting a tax statute?
- In BEPS world, can local tax authorities override arm's length results to target "abusive" transfer pricing?

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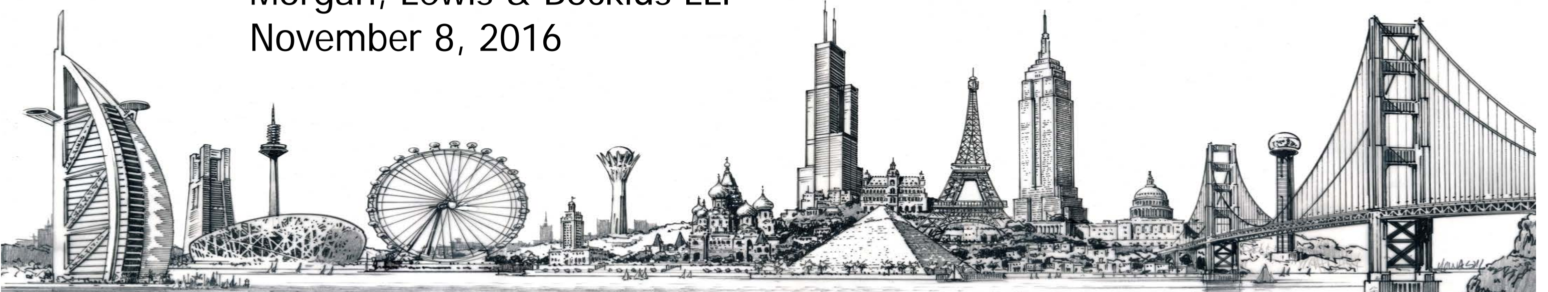
TRANSFER PRICING CONTROVERSY UPDATE

Sanford Stark
Morgan, Lewis & Bockius LLP
November 8, 2016



The Context

"The IRS has designated transfer pricing as a key focus of its international compliance initiatives. Transfer pricing issues account for approximately 46 percent of the Large Business and International Division's international issues inventory and 71 percent of the potential total dollar adjustment amounts of all international issues."

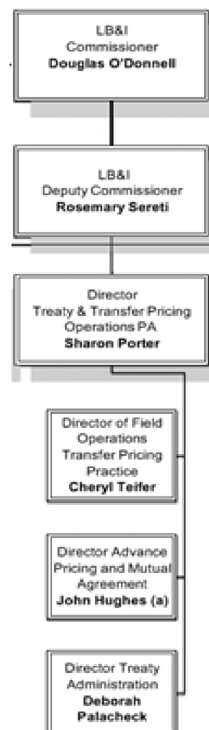
– *Barriers Exist to Properly Evaluating Transfer Pricing Issues,* report of the Treasury Inspector General for Tax Administration, September 28, 2016 (released November 3, 2016)

Agenda

- IRS Audits
- IRS Appeals
- APA and Competent Authority (APMA)
- U.S. Litigation

LB&I Restructuring

- LB&I restructuring (Feb. 2016) → Single LB&I (domestic and international)
- Realignment of resources into 9 practice areas, 5 grouped by subject matter, including the Treaty and Transfer Pricing Operations (TTPO)
  - Transfer Pricing Practice (TPP)
  - Advance Pricing and Mutual Agreement program (APMA)
- Campaigns are part of LB&I's new centralized risk identification strategy, meant to phase out continuous audits
- Campaigns not yet formally disclosed, but prior indications suggest at least one will be focused on transfer pricing

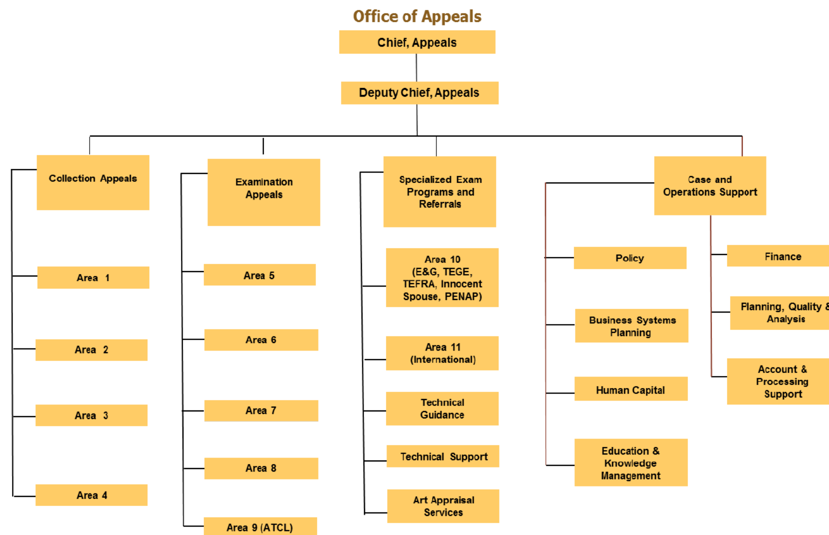


Transfer Pricing Audits

- TPP oversight and coordination
- Increasingly expansive audits
  - More IDRs
  - More formal interviews
  - More site visits (domestic and international)
  - Involvement of counsel and subject matter experts (internal and external)
  - Requests for multiple statute extensions
- International Practice Units (IPUs): Guidance to examiners
  - Comparing arm's length standard with other valuation approaches – outbound/inbound (September 23, 2016)
  - Identifying Foreign Goodwill or Going Concern (October 13, 2016)
- Increasing international information sharing and prospects for bilateral or multilateral audits

IRS Appeals

- Appeals staffing decreased nearly 21% between FY12-FY15
- IRS Appeals reorganization – effective October 2, 2016



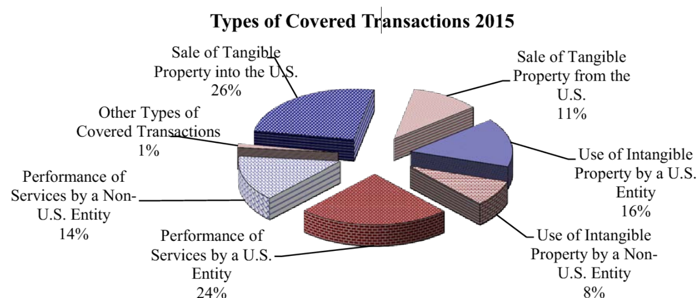
IRS Appeals (cont'd)

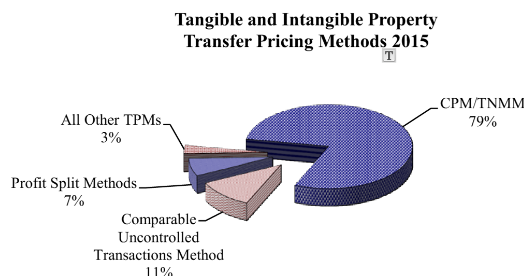
- Appeals may, in its discretion, include IRS counsel and/or Exam in Taxpayer's Appeals conferences without violating "ex parte" communication rules. – I.R.M. 8.6.1.4.4 (10-01-2016)

- Rumors dispelled regarding potential transfer of Appeals Team Case Leaders' final settlement authority to a centralized team
  - "Settlement authority will remain with the ATCLs and Appeals will revise our procedures to make it clear that a manager must review a case prior to an ATCL finalizing a settlement to determine whether the manager has any proposed changes." -- November 4, 2016 letter from Kirsten Wielobob, Chief of IRS Appeals

- "Appeals will return non-docketed cases to Examination when a taxpayer submits new information or evidence or raises a new issue that merits investigation or additional analysis." – Fact Sheet, *IRS Clarifies Office of Appeals Policies* (October 1, 2016)

APAs – Annual Report Data





APA – Selected recent developments

- **United States:** Increase in APA applications filed between 2014 (108) and 2015 (183), but decrease in average months to complete unilateral and bilateral APAs between 2014 (38.3 months) and 2015 (36.7 months)

- **China:** APA procedure changes (Oct. 2016) prompted by BEPS. Notice No. 64 updates guidelines by setting out prescriptive application requirements. Formalistic 6-step approach; detailed data (incl. location-specific advantages and inclusion of a "value chain analysis")

- **India:** In February, USCA reached agreement with India's Central Board of Director Taxes to resume bilateral APA proceedings, ending the suspension of transfer pricing dispute resolution relations between the two countries in effect since 2013.

- **Mexico:** On October 14, IRS announced that taxpayers with maquiladora operations in Mexico will no longer be exposed to double taxation if they enter into a unilateral advance pricing agreement with the Large Taxpayer Division of Mexico's state tax administration (SAT) under terms discussed in advance by the U.S. and Mexico.

MAP – Current Developments (2015)

- Vast majority of concluded MAP cases involved foreign-initiated adjustments (171 out of 193)
- Increasing number of pending cases:

Pending Requests[2]

	U.S. Initiated Adjustments	Foreign Initiated Adjustments	Combined[2]
2011	-	-	**312**
2012	-	-	**403**
2013	91	433	**524**
2014	126	592	**718**
2015	152	603	**755**

- Increasing average processing time (months):

Table 5: Average Processing Time (months)

	U.S. Initiated Adjustments	Foreign Initiated Adjustments	Combined
2011	28.2	27.8	**27.9**
2012	23.1	26.6	**26.0**
2013	23.8	26.9	**26.1**
2014	15.0	25.3	**21.4**
2015	27.7	32.7	**32.1**

U.S. Litigation

- **Notable cases include:**
  - Altera
  - 3M
  - Medtronic / Guidant / Eaton / Zimmer
  - Amazon.com
  - Coca-Cola
  - Microsoft
  - Facebook

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Acquisition Specific RAB Share

TEI-SJSU High Tech Tax Institute (32ND Annual)
November 8, 2016 | Crowne Plaza Cabana | Palo Alto, CA

Drew Crousore

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Scenario

- USCo and FCo are participants in a CSA
- USCo territory is North America and FCo territory ROW
- RAB Share is 50/50
- USCo pays $200 million to acquire a Target Co
  - 100% of Target Co's revenue in North America (5 years preceding acquisition)
  - Current Target Co products only marketable in North America
  - FCo wishes to contribute to development of future products that may benefit ROW (5 year Development Cycle)

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Emerging Issue

- IRS Audit Position – The Acquisition Price Method ("APM") is the best method for determining the value of the PCT. Applying the APM requires utilization of the single RAB share utilized by the cost sharing participants. FCo must pay $100 million for the PCT.
- Arm's Length?

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Altera v. Commissioner

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Altera – Main Findings

- Held: Treas. Reg. §1.482-7(d)(2) (2003) fails to satisfy State Farm's "reasoned decision making standard" – the regulation is invalid
- Building Blocks
  - The final rule is a legislative rule, i.e., it has the force of law
  - State Farm and Chevron (Step 2) coexist
  - Treasury failed to support conclusion
  - Failure not the result of "harmless error"

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Legislative v. Interpretive Rules

– *American Mining Congress v. Mine Safety & Health Administration*, 995 F.2d 1106 (D.C. Cir. 1993): Multi-Part Test (cited in *Altera*, slip op. at 34)

1. Whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties.
2. Whether the agency has explicitly invoked its general legislative authority.
3. Whether the rule effectively amends a prior legislative rule.

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Chevron

– The *Mead* Formulation of *Chevron* Deference

- "When Congress has 'explicitly left a gap for an agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,' *Chevron*, 467 U.S. at 843-44, and any ensuing regulation is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute. *See id.*, at 844; *United States v. Morton*, 467 U.S. 822, 834 (1984); APA, 5 U.S.C. §§ 706(2)(A), (D)."

– The Tax Court: "*Chevron* step 2 incorporates the reasoned decisionmaking standard of *State Farm*." Slip op. at 47-48.

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Arbitrary or Capricious Agency Action

- 5 U.S.C. § 706(2)(A): "The reviewing court shall . . . hold unlawful and set aside agency action . . . found to be . . . arbitrary, capricious, an abuse of discretion, or not in accordance with law."
- "Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *State Farm*, 463 U.S. 29 (1983).
- The Tax Court: "The Final Rule Must Satisfy *State Farm*'s Reasoned Decisionmaking Standard." Slip op. at 43.

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Arbitrary or Capricious Agency Action, cont.

- Four Separate Dispositive Grounds Under *State Farm*.
  1. The Final Rule lacks a basis in fact.
     - The Commissioner conceded that:
       a. Treasury believed it was not obligated to engage in fact-finding.
       b. Treasury's files contained no evidence to support the belief that unrelated parties would share SBC.
       c. Treasury did not search any database that contained arm's-length contracts.
       d. Treasury was unaware of any written agreement in which unrelated parties agreed to share SBC.
  2. Treasury failed to rationally connect the choice it made with the facts found.
     - Treasury treated all QCSAs identically but failed to explain why in the preamble.
     - The failure to explain renders the rule invalid.

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Arbitrary or Capricious Agency Action, cont.

– Four Separate Dispositive Grounds Under *State Farm*.

3. Treasury failed to respond to significant comments.
   - Commentators said they:
     a. Knew of no agreements that required unrelated parties to share SBC.
     b. Found no agreements in which unrelated parties agreed to share SBC.
     c. Searched EDGAR and found no agreements in which unrelated parties shared SBC.
     d. Identified arm's-length agreements in which SBC was not shared or reimbursed.
     e. Identified provisions in the FAR that prohibited reimbursement for SBC in government contracts.
   - The Tax Court concluded that "[m]eaningful judicial review and fair treatment of affected persons require 'an exchange of views, information, and criticism between interested persons and the agency.'" Slip op. at 65.
4. The final rule is contrary to the evidence before Treasury.

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After *Altera* is Affirmed

Treatment of the US Participant's SBC Reimbursement

Fred Chilton, KPMG, Silicon Valley

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Altera-The SBC Reimbursement Provision

Many cost sharing agreements ("CSAs") contain a provision, which was added to the CSA after the *Xilinx* opinion, which states as follows:

In the event that the stock based compensation regulations are held invalid, amounts that were paid for stock based compensation ("SBC") by the Foreign CSA Participant in prior years ("Prior Years SBC") will be reimbursed by the US CSA Participant to the Foreign CSA Participant in the year the regulation is held invalid (the "Current Year"). The Parties agree that such reimbursement will be made: first by the allowance of a offset to the Foreign CSA Participant against the Foreign Participant's share of IDCs incurred in the Current Year; and that any excess of the SBC reimbursement over the Foreign CSA Participant's amount of IDCs for the Current year shall be refunded as a cash payment.

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Altera- An SBC Reimbursement Example

IDC Payments Made in Prior Years of Cost Sharing Agreement. Assume the US CSA Participant has incurred $100 of intangible development costs ("IDCs') per year pursuant to a cost sharing agreement over a period of 5 years. Of the $100 of annual IDCs, $24 were for SBC. Assume further that the foreign participant incurred no IDCs directly in any of the five years. The reasonably anticipated benefits ("RAB") of each of the participants is 50% for each of the five years. Thus, the foreign participant has paid $50 per year to reimburse the US participant for its IDCs and of that amount $12 per year was for SBC. In the years in which such payments were made by the foreign participant, Treas. Reg. section 1.482-7(d)(2) required that such SBC costs be shared by the foreign participant.

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Altera-A SBC Reimbursement Example

IDC Payments Made in Prior Years of Cost Sharing Agreement. **The effect of the foreign participant's payments during the five years was to reduce the US participant's research and development deductions under section 174 of the Code by $50 in each of the five years. The foreign participant has paid the US participant $12 per year for the prior 5 years (a total of $60) for SBC incurred by the US participant.**

Year of Final Decision. **Assume that in the year the regulation is held invalid, the US cost sharing participant incurs $100 of IDCs. The RAB share for the Final Decision year is 50-50. The foreign participant would otherwise pay the US cost sharing participant $50 to share IDCs. The amount of the SBC reimbursement ($60) is bifurcated into: (1) a $50 offset against current IDCs; and (2) a $10 payment from the US participant to the foreign participant.**

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Treatment of the SBC Reimbursement Offset and Refund

The Offset

Different Approaches

The $50 offset might create a federal tax benefit in one of two ways. The offset might be treated as an increased amount of R&D expenses of the US participant in the year of a Final Decision (under the "Simple Approach"). Alternatively the offset might be treated as a payment, the character of which would have to be determined under an analysis under which the offset is treated as a refund and a payment of current IDCs (under the "Deemed Payment" Approach).

The Simple Approach

The Simple Approach results in the US participant's R&D expense being increased. In the example above, the foreign participant has paid SBC IDC reimbursements in prior years of $60, the current IDCs (not including SBC IDCs) are $100 and the RAB shares are 50-50. Absent a Final Decision the foreign participant would owe $50 for current IDCs. The $50 SBC reimbursement offset would cause the foreign participant to make no contribution to current IDCs in the year the SBC regulations are held invalid. With no contribution from the foreign participant, the US participant's contribution to IDCs would be $100.

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Treatment of the SBC Reimbursement Offset and Refund

The Offset

The Simple Approach

Under this approach, the US participant's $100 deduction for IDCs would presumably be taken under section 174 of the Code. The Simple Approach is the one that taxpayers would likely advocate because of its simplicity.

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Treatment of the SBC Reimbursement Offset and Refund

The Offset

The Two Deemed Payment Approach

The Deemed Payment Approach is one in which the $50 offset would be treated as giving rise to two deemed payments of $50: (1) from the US participant to the foreign participant; and (2) from the foreign participant to the US participant. The net effect of the two deemed payments is that the foreign participant is not out of pocket cash. Thus, under the Deemed Payment Approach, the US participant is treated as if it made a $50 deemed payment to the foreign participant and an actual payment to the foreign participant of $10. The Deemed Payment Approach for offsets would likely be advocated by the IRS because it requires the taxpayer to justify a deduction for the deemed payment in reimbursement of the prior year's SBC.

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Treatment of the SBC Reimbursement

The Offset

The Two Deemed Payment Approach

Justification of Deduction for SBC Repayment

Taxpayers wishing to support a deduction for SBC repayment in a situation in which the IRS advocates the Two Deemed Payments Approach will do so by citing: (1) the Supreme Court's "claim of right" decisions to justify the timing of the deduction (in the year the SBC repayment is made); and (2) the "relationship-back" cases (e.g. *Arrowsmith)* to confirm the character of the repayment (as an R&D cost).

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