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International Tax Cases to Watch in 2019

By **Natalie Olivo**

Law360 (January 1, 2019, 12:03 PM EST) -- The Internal Revenue Service is facing several high-stakes cases in the coming year that concern whether the agency abused its discretion in reallocating income to U.S. entities from their foreign affiliates.

More than just taxable income is on the line in some of the cases. For example, chipmaker Altera is challenging the validity of a set of the agency's cost-sharing regulations, and a Coca-Cola case raises the question of whether the IRS can turn its back on a transfer pricing method after allowing it for years under an expired agreement.

At stake in Medtronic, along with a $1.36 billion tax deficiency, is the question of how much discretion a company has in applying the comparable uncontrolled price method, long favored by judges in transfer pricing cases.

Here are five international tax cases worth watching in 2019.

Altera's Second Challenge to Cost-Sharing Rules

This closely watched case centers on a challenge brought by Altera Corp., an Intel subsidiary, against an IRS regulation that requires businesses to include stock-based compensation in their cost-sharing agreements with related parties.

California-based Altera had brought its case in response to deficiency notices saying payments from a Cayman Islands subsidiary under an agreement to share research and development costs were short $80 million in light of the cost-sharing rule. The U.S. Tax Court invalidated the regulation in July 2015 in a decision that is now on appeal before the Ninth Circuit.

The appeal goes to fundamental questions about the arm's-length standard. Altera maintains the IRS ignored evidence in the form of agreements between unrelated parties that didn't require sharing stock option costs, while the IRS argues that those agreements don't resemble cost sharing and that true arm's-length behavior would be to share stock option costs. A government attorney said during oral arguments in October that the appeal boils down to "what does arm's-length mean, and who gets to say what it means?"

The arguments were the second round in the appeal, which has an unusual history. Judge Stephen

Reinhardt, who had heard the first round of arguments in the case, died in March, but the court issued an opinion siding with the government in July, saying he had "fully participated" in the case as one of the 2-1 majority. Then the court withdrew the ruling in August, saying it wanted to allow a reconstituted panel to consider the case.

In the withdrawn decision, the majority on the Ninth Circuit panel disagreed with the U.S. Tax Court's conclusion that the IRS had ignored significant evidence and public comments while issuing its cost-sharing rule.

During the October oral arguments, the new panel — which includes Judge Susan Graber, appointed to the case after the death of Judge Reinhardt — didn't seem to focus much on rulemaking requirements under the Administrative Procedure Act, or APA, according to Kostelanetz and Fink LLP partner Bryan Skarlatos.

Based on that observation, he said the opinion from the new panel is likely to be the same as the withdrawn decision.

"Judge Graber did not seem to really get into the specific requirements under the APA, and that is the heart of the taxpayer's case," Skarlatos said.

The new opinion may engage with procedural aspects under the APA more than the withdrawn decision did, according to Edward L. Froelich, of counsel at Morrison & Foerster LLP. However, he noted the core of the dispute centers on whether the U.S. Department of Treasury has the authority in a transfer pricing context to make related parties share something that unrelated parties don't.

Froelich said Section 482 of the Internal Revenue Code intends for the arm's-length principle to always be applied, noting that Treasury itself offered that same interpretation when it published white papers in response to amendments to the federal tax law made in 1986.

"The commensurate-with-income standard is used and utilized in tandem with that," he said. "It is not intended to be an alternative ground for assessing the transfer price between related parties."

The standard, added to Section 482 in 1986, gives the IRS the power to adjust the price paid in an intercompany transfer when the profits resulting from the transfer don't align with what was paid.

Froelich said the court could find that another part of Section 482 enables Treasury to decide a sharing standard based on the commensurate-with-income principle alone -— an argument the government made before the initial panel, with temporary success.

But the argument is problematic for the government because "the preamble for the final regulations did not say that," he said, adding that the Tax Court had found Treasury failed to follow procedures under the APA.

William Byrnes, an executive professor at Texas A&M University School of Law, predicted the Ninth Circuit will side with the government. But he also said any IRS win would ultimately be overturned by the U.S. Supreme Court because its newest justice, Brett Kavanaugh, is unfriendly to the notion of automatically acquiescing to administrative agencies' interpretation of legislation passed by the U.S. Congress.

“Kavanaugh’s looking for a case, and this is going to be his case,” Byrnes said.

The case is Altera Corp. and Subsidiaries v. Commissioner of Internal Revenue, case numbers 16-70496 and 16-70497, in the U.S. Court of Appeals for the Ninth Circuit.

Doubt Over Medtronic's Win After 8th Circ. Ruling

Like the Altera case, Medtronic Inc.’s transfer pricing dispute stems from accusations that the IRS overstepped its authority.

The U.S. Tax Court in June 2016 squarely rejected the IRS’ $1.36 billion tax deficiency calculation, finding the agency’s calculations for intercompany license royalty rates didn’t reflect a Puerto Rican subsidiary’s contributions to the medical device maker's profits.

However, the Eighth Circuit struck a blow to Medtronic in August when it vacated the Tax Court decision and ordered Judge Kathleen Kerrigan to justify more extensively her determination that Medtronic's overall transfer pricing method was correct.

When arguing before the Eighth Circuit, the IRS had contended that Judge Kerrigan failed to apply the required regulatory analysis in selecting the comparable uncontrolled transaction, or CUT, method for determining the arm’s-length royalty rate that the Puerto Rican subsidiary owed Minnesota-based Medtronic for licenses in 2005 and 2006.

According to the agency, Judge Kerrigan had skirted the analysis required under transfer pricing regulations when she concluded that a license agreement between Medtronic and a company that had been its competitor, Siemens Pacesetter Inc., was a CUT.

Even after Judge Kerrigan provides additional explanation of her analysis, it’s possible that the CUT method won’t pass muster before the Eighth Circuit.

While it’s certainly possible the panel could accept the CUT method after Judge Kerrigan provides further explanation, the language of the opinion suggests the judges were unconvinced by the Tax Court’s application of the CUT, even with adjustments, according to Alston & Bird LLP partner Ryan Kelly.

He noted that if the panel decides CUT isn’t the best approach given the facts and circumstances, the outcome of the judges’ rejection is unclear.

For example, Kelly said, the case could be sent back to the Tax Court so that a different approach can be applied — such as the comparable profits method, which takes into account profits from similar firms. It’s also possible Medtronic could file a motion for reconsideration or request a rehearing en banc, he noted.

“There is a fair likelihood that the service will obtain a better result than it did with the Tax Court’s original opinion,” Kelly said. “However, it is too early to know whether this case will turn out to be considered a win for the service because the litigation process is a long way from completion.”

Froelich, on the other hand, didn’t look at the decision as expressing skepticism toward the CUT method. Rather, he thought the panel wanted the Tax Court “to put it through its paces” to provide further analysis about its independent determination on the valuation of the appropriate transfer price for the royalties.

“I wouldn’t read anything more into the way in which it did that,” he said, noting that the Eighth Circuit didn’t restore the IRS’ transfer pricing conclusion.

“The Tax Court’s conclusion that the IRS’ proposed adjustments under Section 482 were arbitrary and capricious was not criticized by the Eighth Circuit,” he said, noting the IRS itself did not try to rehabilitate its own position on appeal.

The case is Medtronic Inc. v. Commission of Internal Revenue, case number 17-1866, in the U.S. Court of Appeals for the Eighth Circuit.

Amazon and Its ‘Crown Jewels’

Amazon’s dispute centers on a cost-sharing arrangement the Seattle-based company entered into in 2005, under which its Luxembourg affiliate, Amazon Europe Holding Technologies SCS, was granted the right to use certain intangible assets in Europe in exchange for an upfront “buy-in payment” and subsequent annual payments for ongoing intangible development costs.

The IRS had made substantial transfer pricing adjustments that reallocated income from AEHT in Luxembourg to Amazon.com Inc. in the U.S. and accordingly assessed more than $234 million in deficiencies for the 2005 and 2006 tax years. However, the Tax Court found in March 2017 that the methods Amazon used to determine payments from AEHT for the licensing of intellectual property for online European operations were reasonable.

With its win now on appeal before the Ninth Circuit, Amazon contends the IRS is misapplying regulations and definitions under the Internal Revenue Code to retroactively change the cost-sharing rules that governed the parties in 2005.

For its part, the IRS pointed out to the Ninth Circuit that the Tax Cuts and Jobs Act, enacted in December 2017, expanded the definition of intangibles and broadened a catchall category to clarify, rather than change, the existing definition of intangibles.

In practice, companies wouldn’t give away their “crown jewels” for a buy-in payment, according to Byrnes, the Texas A&M professor. However, he noted that Amazon effectively isn’t handing over its intangibles.

“They’re not alienating their crown jewels,” he said, noting that the company is instead contributing its property to a platform that involves sharing and “they’re getting a payment for it.”

The case is Amazon.com Inc. v. Commissioner of Internal Revenue, case number 17-72922, in the U.S. Court of Appeals for the Ninth Circuit.

Coca-Cola’s Fight Against Its $3.3 Billion Tax Bill

At stake in Coca-Cola's transfer pricing case are tax deficiencies of $3.3 billion for the years 2007 to 2009. That amount is based on IRS income allocations of $9.4 billion to the Atlanta-based company from units in Ireland, Swaziland, Mexico, Brazil, Chile, Costa Rica and Egypt, according to a petition filed in December 2015.

Regarding the Mexican unit, the IRS had determined it was paying its parent company a less-than-arm's-length royalty for licensed intangible property, such as beverage bases and other intellectual property used to make the drink. After adjusting that royalty, the IRS found the Mexican licensee now had a reduced income and was therefore paying too much in tax to the Mexican government.

However, in granting partial summary judgment to Coca-Cola, Tax Court Judge Albert Lauber in December 2017 reinstated the $139 million in foreign tax credits that the IRS had denied the beverage giant. The rest of the case went to a trial in March that lasted roughly two months. It's currently in the post-trial briefing process.

In his partial summary judgment ruling, Judge Lauber noted that the royalty payments were calculated under a method that both the IRS and the Mexican tax authority had signed off on over two decades ago — a method Coca-Cola's tax adviser recommended using even after the government agreements expired.

This case is important because it will consider whether the IRS' rejection of a closing agreement, which set forth a transfer pricing method and which Coca-Coca followed for years afterward, is a relevant factor in evaluating whether the agency abused its discretion, according to Froelich at Morrison & Foerster.

"Secondly, the court may consider whether it is relevant that the taxpayer relied upon this methodology to its detriment in the years at issue," he said.

Froelich said that during this time, the IRS examined the company's returns for each of the 11 post-closing agreement years and concluded that, to quote the Tax Court's interpretation, "the continuing application of the closing agreement's terms and conditions to post-1995 years seems appropriate."

The case is Coca-Cola Co. et al. v. Commissioner of Internal Revenue, docket number 31183-15, in the U.S. Tax Court.

Unfinished Business Surrounding Eaton's Canceled APAs

Eaton Corp.'s case centers on the agency's decision to cancel two advance pricing agreements it negotiated with the Ohio-based power management company that determined the price for transactions with its Caribbean subsidiaries.

The U.S. Tax Court concluded in July 2017 that the cancellation, which led the IRS to increase Eaton's 2005 and 2006 taxable income by roughly $370 million, was an abuse of discretion.

Judge Kerrigan said in a 202-page ruling that the IRS missed its chance to question the advance pricing agreements, or APAs, involving Eaton's foreign subsidiaries.

But the dispute didn't end there. The Tax Court ruling against the IRS left a key question unanswered: how to calculate the accuracy-related penalty imposed on Eaton in light of the canceled APAs.

During an oral status hearing in October, Judge Kerrigan cited penalty rules under the revenue code saying a taxpayer can be found to have made a "substantial valuation misstatement" if a transfer price adjustment under Section 482 for a taxable year exceeds the lesser of $5 million or 10 percent of the taxpayer’s gross receipts.

Detailed arguments about what underpayment penalty Eaton should face are needed, the judge said at the hearing, because at the time of her 2017 opinion, “the 482 issue wasn’t decided.” Furthermore, the court hadn’t thought a penalty issue existed because the APAs to which those determinations applied had been upheld.

An attorney for Eaton told the judge during the hearing that the question of whether the company would base its defense on the amount of penalty imposed was superseded by a challenge to whether a penalty even applies.

Throughout the case, which began in 2012, Eaton has argued that its errors in executing the agreements at issue were strictly computational and didn’t warrant cancellation. Instead, the company contended it should have been allowed to correct the APAs.

If anything comes out of the Eaton case, it might be that the IRS is less likely to cancel APAs in the future because of the lengthy transfer pricing litigation that has ensued, according to Alston & Bird’s Kelly.

But he also said the case is so unusual it is likely to have limited application to other situations.

“The Eaton case should be viewed as an isolated occurrence that is extraordinarily rare, “ Kelly said.

The case is Eaton Corp. et al. v. Commissioner of Internal Revenue, docket number 5576-12, in the U.S. Tax Court.

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