

IRS Must Rethink Transfer Pricing Cases After Amazon Loss

By **Vidya Kauri**

Law360, New York (March 24, 2017, 10:20 PM EDT) -- The Internal Revenue Service's blistering loss in a \$1.5 billion transfer pricing dispute with Amazon has experts calling for a re-examination of the agency's valuation methodologies in order to prevent it from wasting its own resources and those of taxpayers.

The IRS had disagreed with the amount of upfront and regular payments that Amazon.com Inc.'s subsidiary in Luxembourg paid to the Seattle-based retailer in exchange for the right to use certain intellectual property for online European operations.

Using methodologies the U.S. Tax Court had already knocked down in another transfer pricing lawsuit against Veritas Software Corp. in 2009, the IRS made substantial transfer pricing adjustments that reallocated more income from Amazon's European subsidiary to its U.S. operations and assessed more than \$234 million in deficiencies for the 2005 and 2006 tax years. The IRS' position could have resulted in an overall tax liability of \$1.5 billion, plus interest, Amazon estimated.

Somewhat predictably, U.S. Tax Court Judge Albert Lauber noted the similarities between the Amazon and Veritas cases, and reprimanded the IRS for being "unreasonable" and for abusing its discretion in reaching its conclusions. Amazon's methodologies, with some adjustments, were more reasonable, he said.

The IRS, which declined to comment for this story, has not fared well in transfer pricing lawsuits in general. While the Amazon case may be viewed as a reboot of Veritas in many respects, the agency has lost other high dollar-value cases against other major corporations, including Altera Corp. and Medtronic Inc.

The agency's reliance on arguments that it has already lost is confounding and suggests it doesn't fully understand the economics of transfer pricing, Larissa Neumann, a tax partner at Fenwick & West LLP, said.

"They put their best people on this case, and again, they're wasting resources to relitigate these same issues," Neumann said. "Taxpayers are frustrated. They're continually having to fight these same battles over and over again. It's a waste of resources on both sides."

While Amazon had presumed its intangibles had a seven-year shelf life and calculated a \$255 million payment from its subsidiary for the use of pre-existing intangibles such as software, trademarks and customer information, the IRS postulated an indeterminate useful life and estimated a much larger

payment of approximately \$3.5 billion for Amazon U.S.

Such a wide disparity, in the context of the Veritas case and other losses, raises a red flag about whether the IRS actually appreciates the factual underpinnings of transfer pricing transactions and the methodologies used by taxpayers, according to Brian Kittle, co-leader of Mayer Brown LLP's tax controversy and transfer pricing practice.

"The IRS continues to take a square peg--round hole approach. It continues trying to push that square peg into that round hole regardless of the facts and circumstances presented," Kittle said.

Mark Allison of Caplin & Drysdale Chtd. said the IRS isn't necessarily being irresponsible by scrutinizing and litigating transfer pricing issues, since these cases tend to be very fact-driven with the circumstances of each one needing to be considered individually, and the agency has a mandated responsibility to protect its tax base.

"The IRS quite understands that there are transfer pricing strategies that are out there that are designed to move this kind of value offshore, and the IRS has every economic incentive to change those dollars," Allison said.

While the Amazon and Veritas cases are similar in many respects, the IRS' presentation of its arguments was different in Amazon in terms of the way the agency and its experts characterized the valuation process. For example, the IRS tried to argue it was basing its calculations on a 20-year value for the intangibles and not a perpetual life as in Veritas, but Judge Lauber said the agency clearly valued the intangibles as if they would retain value forever.

The government sometimes tries to relitigate issues by trying out different arguments and theories to defend its position, Allison said. However, the Tax Court has now made it clear that it won't give the IRS a free pass despite its broad powers to make its own transfer pricing determinations under Section 482 of the Internal Revenue Code, and experts say the agency needs to take a step back, re-evaluate its approach to transfer pricing cases and re-examine the kinds of cases it chooses to litigate.

"From a resource perspective, this is very expensive to litigate," Allison said. "It is very expensive to hire all these experts, and ... it's not a good use of resources if they're not being successful here."

The case is Amazon.com Inc. & Subsidiaries v. Commissioner of Internal Revenue, case number 31197-12, in the U.S. Tax Court.

--Editing by Pamela Wilkinson and Philip Shea.