MAYER • BROWN

Transfer Pricing: The New Frontier

Arm's Length Standard in a Post-BEPS World

December 6, 2018

Today's Speakers

Astrid Pieron
Partner, Brussels
apieron@mayerbrown.com

Scott Stewart
Partner, Chicago
sstewart@mayerbrown.com

Elena Khripounova
Director of Transfer Pricing and Valuation Services, Washington, DC
ekhripounova@mayerbrown.com

Agenda

- Arm's Length Standard
  - The Basics
  - Why adopted?
  - Why viewed as flawed?
- Developments in the Analysis of Functions, Assets, and Risks
  - Key concepts
  - Realistic alternatives, commercial rationality
  - Risk analysis
  - Value chain
  - Intangibles
  - Financial transactions
- Arm's Length Principle in Europe: Recent Developments
- Litigation Update
- Closing Remarks

ARM’S LENGTH STANDARD: THE BASICS

Arm’s Length Standard: The Basics

- **Article 9 of the OECD Model Tax Convention defines Arm’s Length Principle as follows:**

  Where “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”

- **OECD TPG explains further that**

  “By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. in “comparable uncontrolled transactions”), the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business”

- **…and**

  Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a “comparability analysis”, is at the heart of the application of the arm’s length principle”

Arm’s Length Standard: The Basics

- **Why ALS was adopted**
  - ALS puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity
  - ALS has also been found to work effectively in the vast majority of cases
- **Why viewed as flawed?**
  - The separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses
  - A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake
  - The arm’s length standard may result in an administrative burden for both the taxpayer and the tax administrations of evaluating significant numbers and types of cross-border transactions

=> BEPS Actions designed to address these issues

DEVELOPMENTS IN THE ANALYSIS OF FUNCTIONS, ASSETS, AND RISKS

OECD BEPS Actions 8-10: A Few Key Concepts

- BEPS Actions 8-10 Final Reports "**Aligning Transfer Pricing Outcomes with Value Creation**" published October 2015.
- Incorporated in OECD Transfer Pricing Guidelines ("TPG") in July 2017
- "**Realistic alternatives**" and "**commercial rationality**" move to the forefront
  - "The key question in the analysis is whether the actual transaction possesses the **commercial rationality** of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. … the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement" TPG ¶1.123
- "**Perspectives of each of the parties** to the transaction" TPG 2017, ¶6.112
- Reports focus on "**value chain**" over specific transactions between specific related parties.
  - "it is important to understand **how value is generated by the group** as a whole, the **interdependencies of the functions** performed by the associated enterprises with the rest of the group, and the **contribution that the associated enterprises** make to that value creation" TPG ¶1.51

OECD BEPS Actions 8-10: More Key Concepts

- BEPS Actions 8-10 emphasize the **performance of functions and exercise of "control"** over contractual terms and ownership of assets
- **"Economically Significant Risks"** – The risks with the biggest impact on the bottom line
- **"Control" –** The Revised Chapters 1 and 6 revisions contemplate that some degree of "control" will be needed for:
  - A contractual assumption of risk (including economically significant risks) to be respected;
  - The provision of funding to earn more than a risk-free return; and
  - An intangibles owner to reap (non-routine) intangibles-related returns when it outsources DEMPE functions

- Treas. Reg. § 1.482-1(d)(3)(iii)(B)(2) – "[T]he allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the ***economic substance*** of the transaction." …where factors relevant to economic substance include:
  - ***Conduct*** over time
  - ***Financial capacity*** to bear losses
  - The extent of ***managerial or operational control***

Realistic Alternatives; Commercial Rationality

- The concepts of **economic substance** and **realistic alternatives** are not new:
  - The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer… [and] may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer. Treas. Reg. § 1.482-1(f)(2)(ii)(A)
  - Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. (See 1.482-1(d)(3)(iv)) … including "the alternatives realistically available to the buyer and seller." Treas. Reg. § 1.482-1(d)(3)(iv)(H)
  - In evaluating an intangible, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. Treas. Reg. § 1.482-4(d)(1)
  - The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable. Treas. Reg. § 1.482-7(g)(2)(iii)(A)

BEPS Actions 8-10 Risk Analysis

- **2017 TPG Risk Analysis is a six step process**
  - Step 1: Identify economically significant risks with specificity
  - Step 2: Determine contractual assumptions of risk
  - Step 3: Functional analysis of risk
  - Step 4: Interpret Steps 1-3

    Consider:

      (i) Conduct

      (ii) Control and capacity
  - Step 5: Allocation of risk
  - Step 6: Pricing of the transaction, taking account of the consequences of the risk allocation

Value Chain Analysis

- Section A.3.1. *"Evaluation of a taxpayer's **separate and combined** transactions"* has not changed
  - "[T]here are often situations where separate transactions are so **closely linked or continuous** that they cannot be evaluated adequately on a separate basis." TPG 2017, ¶3.9
- Which echoes the **aggregation principle** in Treas. Reg. § 1.482-1T(f)(2)(i)(A) through (E):
  - The decision to aggregate is based on (i) the extent to which the transactions are **economically interrelated** and (ii) the relative **reliability** of the measure of an arm's length result. The taxpayer must determine whether an **aggregate analysis** of all transactions leads to a more accurate result than a separate analysis of each transaction.
  - … which expired on Sept. 14, 2018 but were accompanied by Proposed Regs, which appear to remain outstanding
- … Plus the Section 482 Amendment in TCJA appears to create bias toward **aggregation**, at least with respect to intangibles:
  - "[T]he Secretary shall require the valuation of intangible property (including intangible property transferred with other property or services) on an **aggregate basis** or the value of such a transfer on the basis of the **realistic alternatives** to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers"

Value Chain Analysis

- "A **value chain** is the **full range** of activities that firms engage in **to bring a product to the market**, from conception to final use. Such activities range from design, production, marketing, logistics and distribution to support to the final customer. They may be performed by the **same firm or shared among several firms**. As they have spread, value chains have become **increasingly global**" (OECD, *Interconnected economies benefiting from global value chains, synthesis report*, Paris, 2013, at 8.)

- Characteristics of Global Value Chains:
  - **Vertical integration** of economic activities
  - …which, at the same time, are **fragmented** and **dispersed** across countries
  - …are increasingly **specialized in tasks and business functions**
  - …and rely on **coordinated networks** of buyers and suppliers

- Review the **substance of the supply chain**: TPG 2017 ¶1.66 "The **capability** to perform decision-making functions and the **actual performance** of such decision-making functions **relating to a specific risk** involve an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business of the enterprise." A mere **contractual form** of the decision-making process is **no longer sufficient** to demonstrate the performance of decision-making functions

Value Chain Analysis: Transactional Profit Split Method

- **Evidence of TPSM use by independent enterprises**
  - "It is sometimes argued that a transactional profit split method is **rarely used among independent enterprises**, and thus its application in controlled transactions should be similarly rare. Where such a method is determined to be the most appropriate, **this should not be a factor** since transfer pricing methods are **not necessarily intended to replicate arm's length behaviour**, but rather to **serve as a means of establishing and/or verifying arm's length outcomes** for controlled transactions." Action 10, ¶2.124
    - Is the above statement consistent with the arm's length standard?
    - If there is no evidence of independent enterprises using TPSM in specific situations, will this be sufficient reason to reject the method?
- **Will TPSM become a default method?**
  - "The existence of **unique and valuable contributions** by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate. …other indicators … include a **high level of integration** in the business operations to which the transactions relate and /or the **shared assumption of economically significant risks**… by the parties to the transactions." Action 10, ¶2.126

Value Chain Analysis: Transactional Profit Split Method

- **Non-recognition of the transaction**
  - "The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction." TPG 2017, ¶1.122
  - The language is very similar to TPG 2010, ¶1.65
- **…but**
  - … "the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement." TPG 2017, ¶1.123
  - Same language in TPG 2017 ¶9.109 and TPG 2010 ¶9.172

Chapter VI: Intangibles

- **TPG 2010**: “For the purposes of this chapter, **the term “intangible property” includes** rights to use industrial assets such as **patents, trademarks, trade names, designs or models**. …**literary and artistic property rights**, and intellectual property such as **know-how and trade secrets**. …**business rights**, that is intangible property associated with commercial activities, including marketing activities. These intangibles are assets that may have considerable value even though they may have no book value in the company’s balance sheet” ¶6.2
- **TPG 2017, ¶6.2**: “[T]he key consideration is **whether a transaction conveys economic value** from one associated enterprise to another... To the extent that an item or activity conveys economic value, it should be taken into account in the determination of arm’s length prices whether or not it constitutes an intangible within the meaning of paragraph 6.6”
- …where **¶6.6** states that “the word ‘intangible’ is intended to address **something which is not a physical asset or a financial asset**, which is **capable of being owned or controlled** for use in commercial activities, and **whose use or transfer would be compensated** had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction”

Chapter VI: Intangibles

- **"DEMPE" Functions** – <u>D</u>evelopment, <u>E</u>nhancement, <u>M</u>aintenance, <u>P</u>rotection, and <u>E</u>xploitation
  - Per Revised Chapter 6, DEMPE functions are "one of the key considerations in determining arm's length conditions for controlled transaction."
  - In order to be entitled to retain all the returns, a legal owner *must* perform ***all*** of the functions, contribute all assets used, and assume all risks related to DEMPE – but not "physically … through its own personnel"
  - Importance of legal ownership of intangibles is reduced. The allocation of income derived from utilizing a specific intangible will depend on the actual economic functions performed, the assets used and risks assumed in the DEMPE of intangibles.
- Profit or loss relating to differences between actual (ex post) and a proper estimation of anticipated (ex ante) profitability ? Per revised Chapter 6:
  - Which entity or entities in the MNE group in fact assumes the risks as identified when delineating the actual transaction;
  - Which entity or entities which are performing the important functions or contributing to the control over the economically significant risks and;
  - For which it is determined that an arm's length remuneration of these functions would include a profit sharing element.

“Hard-to-Value Intangibles”

- HTVI are intangibles for which, at the time of their transfer between associated enterprises, (1) no reliable comparables exist, and (2) the projections of future cash flows or income expected from the transferred intangibles, or the assumptions used in valuing the intangibles, are highly uncertain. ¶6.189
- *Ex post* outcomes can provide presumptive evidence (…subject to rebuttal, ¶6.188) about the arm’s length nature of the *ex ante* pricing arrangement if the differences are not due to unforeseeable events. ¶6.187
- The use of *ex post* evidence is inappropriate in certain circumstances, including when at least one of the following exemptions applies: (¶6.193)
    - i. The taxpayer provides details of ex ante projections or reliable evidence of unforeseeable developments or the probability of certain foreseeable outcomes
    - ii. The transfer of the HTVI is covered by a bilateral or multilateral APA
    - iii. The difference between financial projections and actual outcomes does not change the compensation for the HTVI by more than +/-20%
    - iv. During 5-year commercialization period, the difference between financial projections and actual outcomes was not greater than 20%

“Hard-to-Value Intangibles”

- **“Burden of Proof”**

  In order to avoid the HTVI label, the Taxpayer is expected to show that (i) the CUTs/CUPs are reliable, and (ii) the projections and assumptions, even if uncertain, appropriately consider the likelihood of the outcome(s).

  - How realistic is this expectation *ex ante*?
  - What is there to prevent every transferred intangible from being labeled HTVI?

- **Presumptive *ex post* evidence of *ex ante* behavior**
  - What would distinguish *ex post* evidence from hindsight?
  - How to “prove” the non-existence of *ex ante* information? Truly *ex ante* “unforeseeable events” may appear “foreseeable” ex post.

“Hard-to-Value Intangibles”

- **Adjustment to Amounts or Adjustment to Pricing Structure**
  - “In implementing the HTVI approach.., tax administrations may make appropriate adjustments, including adjustments that reflect an alternative pricing structure that is different from the structure adopted by the taxpayer (for example, milestone payments, running royalties with or without adjustable elements, price adjustment clauses, or a combination of these characteristics).” Implementation Guidance, ¶12.
  - …*which resonates with* Treas. Reg. § 1.482-1(f)(2)(ii)(A): “The Commissioner… may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative … but will not restructure the transaction as if the alternative had been adopted by the taxpayer.

- **What to do?**
  - Adopt shorter-term agreements
  - Include price adjustment clauses in the terms of the agreement
  - Adopt a payment structure involving contingent payments
  - Include (an)other mechanism(s) to address high uncertainty
  - Include a clause to renegotiate

Draft Guidance on Financial Transactions (July 2018)

- Controversial positions but illustrating the trends
- Identifying the arm's length interest rate is not enough
- Need to first identify what should be treated as a debt for tax purposes
  - Debt should be treated as equity if the borrower cannot service the full amount of the debt
  - Verification of lender/borrower functions
- Guidance on the pricing of financial transactions such as treasury services, loans, cash pooling, hedging, financial guarantees and captive insurance
- It is noted that appropriate interest rates can be identified from similar recent loans to similar borrowers. The guidance also refers to the possibility of building up an interest rate by adding a risk-appropriate "profit margin" to the lender's cost of funds

ARM'S LENGTH PRINCIPLE IN EUROPE: RECENT DEVELOPMENTS

European Developments

- The CCCTB proposal
- Local comparables versus Pan- European comparables?
- EU State aid cases: ALS as a test?

Common Consolidated Corporate Tax Base (CCCTB)

- Single set of rules that would allow companies operating within the European Union (EU) to calculate their taxable profits on a uniform basis and for the aggregate profits to be apportioned between Member States on an agreed basis.
- No transfer pricing issues any more?
- Initially proposed by the EU Commission in 2011
- Revisited in March 2015 through an action plan for “A fair and Efficient Corporate Tax System in the European Union”
- Relaunched in October 2016 as a two steps process:
  - In the first step, the common base should be implemented
  - Consolidation (= cross border loss relief) would be adopted in a second phase
- If adopted, the CCTB would be mandatory and would apply to all groups of companies with a total annual turnover in excess of EUR 750 million and conducting business activities in the internal market through a taxable presence in an EU Member State.

(EU) Local Comparables

- In some Member States, establishing the lack of local independent comparable data is a pre-requisite for using pan-European databases
- When there is a lack of local independent comparable:
  - define a relevant geographic market e.g. similarities in labour cost structures or GDP per capita, could also be useful to define a relevant geographic market on a case-by-case

Pan-EU Comparables?

- Conducting a pan-EU comparable search in accordance with the OECD TPG requires to:
  - refer to the relevant geographic market, which generally includes the territory in which the MNE operate as long as it is homogeneous
  - document the reasons underlying the choice of the region on which his comparable search is based including the extent to which he considers that the economic circumstances matter for the comparable search

State Aid: Introducing ALS as a Test

- State aid consists of any form of “financial advantage” comprising “State resources” which “selectively” advantage an undertaking or group of undertakings.
- A “financial advantage” includes a derogation, waiver or other modification of a tax regime which leads to a company paying less tax than would be due in the normal course.
- The Court of Justice of the European Union has confirmed that if the method of taxation for intra-group transfers does not comply with a market based arm’s-length principle and as a result leads to a lower taxable base, then it provides a selective advantage to the company concerned. However, this interpretation of a single judgment is contested.

LITIGATION UPDATE

Litigation Update

- Several Prominent Tax Cases at Varying Stages Address Comparability Issues:
  - *Amazon* (Appeal in Ninth Circuit on cost sharing dispute, final brief submitted August 2018)
  - *Medtronic* (Eighth Circuit vacated and remanded Tax Court transfer pricing opinion August 2018)
  - *Coca-Cola* (Tax Court opinion in December 2017 on FTC issue, trial on main transfer pricing issues concluded in May 2018, post-trial briefing complete by February 2019)
  - *Eaton* (Tax Court decision in favor of taxpayer on APA cancellation July 2017)
  - *Facebook* (Tax Court trial on cost sharing dispute scheduled for August 2019)

Amazon v. Commissioner

- Recap of Parties' Positions
  - Amazon: the IRS's adjustment was arbitrary, capricious, and unreasonable.
    - The IRS's DCF method improperly valued the platform intangibles into perpetuity.
    - Platform intangibles depreciate rapidly, and thus cannot be treated as having perpetual useful lives.
    - The IRS improperly valued the entire business enterprise, *not* solely the intangibles, using the same "akin to a sale theory" the Court rejected in *Veritas*.
  - IRS:
    - Amazon's platform intangibles will continue to provide value to its future business operations in perpetuity.
    - The intangibles are most appropriately valued in the aggregate.

Amazon v. Commissioner

- Trial Held in Fall 2015
  - Amazon's experts at trial relied on the CUT method to value the intangibles covered by the buy-in at between $284 million and $413 million.
  - The IRS reduced its valuation at trial to $3.468 billion.
- Opinion released on March 23, 2017 (148 T.C. No. 8 (2017))
  - Held: the IRS's adjustment was arbitrary, capricious, and unreasonable, and constituted an abuse of discretion. IRS DCF implicitly includes residual business intangibles (as in *Veritas*).
  - The court also found that the CUT method was the best method to price the buy-in payment (rather than the DCF valuation offered by the IRS).
  - The court adjusted the intangibles' useful lives upwards from 6 years to 7 years (with a 3.5-year tail) for website technology, and upwards from 8-20 years to 20 years for various marketing intangibles.

Amazon v. Commissioner

- Arguments on Appeal
  - IRS (appellant):
    - Residual business intangibles (goodwill, going concern value, etc.) are compensable in the buy-in.
    - The TCJA amendment to the definition of intangibles in section 936(h)(3)(B) (now explicitly including goodwill and going concern value) clarifies Congress's intent regarding the scope of compensable intangibles before TCJA.
    - The IRS's DCF method isolated the value of "pre-existing" intangibles contributed in the CSA, and did not improperly include profits from future-developed intangibles.
    - The Tax Court erred in describing Amazon-Lux's return as $0 under the IRS's DCF method. Rather, the IRS DCF gives Amazon-Lux an 18% expected return.

Amazon v. Commissioner

- Arguments on Appeal (continued)
  - Amazon (appellee): As in *Veritas*, IRS continues to try to use post-2009 additions to the regulations (expansion of income-based methods and realistic alternatives) and an overbroad definition of intangibles.
    - The IRS's preferred method is still "a thinly veiled attempt to subject Amazon to new regulations adopted years after" the transaction.
    - TCJA amendment to section 936 shows Congress wanted to address a recurring issue, without creating an inference regarding prior law.

> "Congress provided that the new law should not be 'construed to create any inference with respect to the application of section 936(h)(3) [before 2018]. . . That instruction bars the commissioner's strained claim that, by adding intangibles like workforce-in-place to section 936(h)(3)(B) in 2017, Congress somehow confirmed that intangibles that are not independently transferable always fell within the statutory definition."

Medtronic v. Commissioner

- Opinion issued on June 9, 2016, T.C. Memo 2016-112
- Key disputes:
  - Section 482: Did Medtronic Puerto Rico make arm's length payments to Medtronic US for IP necessary to manufacture and sell medical devices?
  - Section 367(d) alternative: If the transfer prices are correct, did Medtronic US transfer compensable IP to Medtronic Puerto Rico subject to section 367(d)?
    - Similar alternative arguments, under both 367(a) and (d), were raised in the *Guidant/Boston Scientific* and *Zimmer* cases.
- Five-week trial took place in February-March of 2015.
  - Judge Kerrigan presided (same judge as in *Eaton*)

Medtronic v. Commissioner

- The Tax Court opinion largely supported Medtronic's position.
  - IRS's CPM analysis was flawed.
    - Medtronic Puerto Rico did not simply perform the final manufacturing steps, following processes developed by Medtronic US.
    - Medtronic demonstrated that product quality plays a very significant role in the implantable devices area, and the manufacturer plays a key role in ensuring quality.
    - IRS argued that quality is simply a baseline competency, and that other simple manufacturers could meet the same standards.
  - Judge Kerrigan found that quality is the "single greatest factor in terms of market share."
    - IRS discounted Medtronic Puerto Rico's role – "replaceable" and a "manufacturer of components."
    - Medtronic Puerto Rico was not replaceable and had to ensure components worked perfectly, under very strict FDA regulation.
- Comparables used and ROA analysis by IRS's expert were flawed.

Medtronic v. Commissioner

- The Commissioner's adjustment had other flaws:
  - Aggregation of transactions, while permitted by the regulations, is neither required nor appropriate in the case of Medtronic.
    - Resulting system profits allocated to MPROC were unreasonably small – aggregation was not the most reliable means of determining an arm's length price.
- Medtronic's preferred comparable transaction, the Pacesetter Agreement, can still be used as a CUT:
  - Involved some of the same intangibles in comparable circumstances.
  - Imperfect comparable can still be used if sufficiently similar.
  - IRS's brief on appeal takes issue with several features of this agreement: litigation settlement, cross-license, lump-sum component, different profit potential.
- The final royalties (44% on devices, 22% on leads) are very close to an MOU result that Medtronic negotiated in a prior audit cycle.

Medtronic v. Commissioner

- Appellate Decision, Eighth Circuit August 16, 2018:
  - Vacates and remands the case to the Tax Court for further consideration and explanation. Leaves open whether the magnitude of adjustments was appropriate.
  - Circuit court opinion mirrors IRS criticisms of Tax Court's reliance on a single, adjusted CUT (Pacesetter), but doesn't definitively rule out the use of this comparable.
  - On remand, the Tax Court is instructed to more fully explain its use of the Pacesetter CUT with respect to:
    - Whether a litigation settlement should be considered "ordinary course of business"
    - Effect of lump-sum payment and cross-licenses in Pacesetter on comparability
    - Differences between the scope of Pacesetter (which did <u>not</u> include know-how and other peripheral intangibles) and the intangibles licensed to Medtronic Puerto Rico (which <u>did</u> include such intangibles)

Medtronic v. Commissioner

- Implications for audits:
  - Based on the Tax Court's opinion, courts seem more comfortable with transactional proof (CUT) than profit-based methods (similar to *Amazon*)
  - Profit-based methods are generally easier to use in routine documentation, but transactional methods can be worth the effort:
    - Reliable transactional proof requires time and expense to develop, but consider CUT searches as a confirming method even in routine documentation.
    - If a controversy develops, the transactional proof can be improved and can take on a primary role.
  - Following the Eighth Circuit's opinion, worth watching what the Tax Court does to support, or change, its original position.
    - A second appeal to the Eighth Circuit is possible; could focus on Tax Court's adjustments to the Pacesetter comparable (if relied upon in a new opinion).

Coca-Cola v. Commissioner

- Primary transfer pricing dispute (Trial complete, briefs in progress):
  - Primary positions:
    - IRS arguing Coca-Cola overpaid foreign licensees; these licensees should have lower profits in line with Coca-Cola's bottlers.
    - Coca-Cola arguing that its licensees perform more functions and bear more risk than mere bottlers; the licensees drive local sales growth, manufacture concentrate, make marketing decisions, and monitor local bottlers.
  - In a surprise to many observers, Judge Lauber excluded portions of one of Coca-Cola's expert reports, where summaries of employee interviews were reported and relied upon, rather than full transcripts.

Eaton Corp. v. Commissioner

- Eaton and IRS entered advance pricing agreements (APAs) covering 2001–05 and 2006–10.
  - Covered manufacturing of breaker and electrical control products in Puerto Rico and the Dominican Republic.
  - Modified CUP method that guaranteed U.S. distributor a certain return on expenses (Berry ratio).
  - First APA also included a technology royalty using a CUT.

Eaton Corp. v. Commissioner

- On audit for 2005-06, IRS canceled the APAs and adjusted Eaton’s income.
  - IRS claimed that Eaton misrepresented or omitted material facts in negotiating the APAs and failed to comply with the terms and conditions of the APAs.
  - IRS applied a CPM, which provided Eaton’s foreign manufacturing entities with a return on capital employed for what it viewed as routine contract manufacturing.
- A five-week trial was held in August and September 2015 on both the APA cancellation and substantive transfer pricing issues.

Eaton Corp. v. Commissioner

- The Tax Court held that:
  - The IRS abused its discretion by canceling the APAs.
    - Eaton advocated for the CUP method in combination with the CPM throughout the APA negotiations, and the IRS had multiple opportunities to reject Eaton's method or to suggest a different method; it never did so.
    - Eaton's errors in connection with the APAs were immaterial and inadvertent and not sufficient grounds for the IRS to cancel the APAs and switch to a transfer pricing method it never raised during the negotiations.
  - Eaton did not transfer intangibles subject to section 367(d).

Facebook Inc. v. Commissioner

- Trial scheduled for August 2019
- Tax Court case relates to valuation of cost-sharing buy-in/platform contribution.
  - Beginning in 2011, the IRS audited Facebook's 2008, 2009, and 2010 tax years.
  - In 2016, Facebook refused the IRS's request for the sixth extension of the statute of limitations.
  - The IRS issued a notice of deficiency proposing a transfer-pricing adjustment in Facebook's 2010 tax year. The adjustment relates to a PCT valuation (cost sharing buy-in).
  - While the adjustment in 2010 is small, the effect on later years is substantial (~$5.8B vs. $14B valuations).

CLOSING REMARKS

Arm's Length Standard: Concerns Remain

- BEPS Actions 8-10 guidance on the analysis of *fragmented* yet *integrated* activities raises concern about consistency in application by the various tax administrations
- Reliance on HTVI can make it easier for tax authorities to recharacterize transactions and to use hindsight inconsistent with the arm's-length standard
- The revised analysis of risk can allow tax administrations to disregard contractual allocations of risk, even if priced at arm's length
- We are yet to see how the accurate delineation of the controlled transaction will be performed in practice to be able to conclude that "there is no clearly more attractive opportunity realistically available to meet [taxpayer's] commercial objectives than the transaction adopted"¶1.38
  - Note that the analysis of realistic alternatives is performed before any discussion of pricing
- CbCR requirement of Action 13 raises the specter of formulary apportionment

Arm's Length Standard is Here to Stay

- The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises
- Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations
- Formulary apportionment – the only option seriously discussed as an alternative to ALS – has rampant problems of its own
- Tax administrations expressed commitment to ALS

Disclaimer

The material in this presentation is provided for informational purposes only and does not constitute legal or other professional advice. You should not and may not rely upon any information in this presentation without seeking the advice of a suitably qualified attorney who is familiar with your particular circumstances. Mayer Brown Practices assumes no responsibility for information provided in this presentation or its accuracy or completeness and disclaims all liability in respect of such information.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the “Mayer Brown Practices”) and non-legal service providers, which provide consultancy services (the “Mayer Brown Consultancies”). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.