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U.S. Tax Court rules for IRS on question of aggregation in transfer pricing adjustment

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The U.S. Tax Court on February 29 rejected the taxpayer's motion for summary judgment in the case of *Guidant LLC v. Commissioner*, 146 T.C. No. 5 (2016). The case will now be resolved on the full record as developed at trial, which is set to begin on July 25, 2016, in Chicago.

The Tax Court ruled that, as a matter of law:

- The IRS is not required to determine the "true separate taxable income" of each controlled taxpayer in a consolidated group within the meaning of Treas. Reg. §1.482-1(f)(1)(iv); and
- The IRS did not have to make specific adjustments with respect to each controlled transaction at issue in the case, but could instead aggregate the controlled transactions when exercising its authority under §482.

The Tax Court did not rule on whether the IRS was correct in choosing to do an aggregated valuation in the case, but merely whether the IRS was prohibited from doing so as a matter of law. The Tax Court's finding allows the issue of whether aggregation was appropriate in this case to be decided as a factual matter at trial.

This case involves Guidant LLC, a cardiac medical device maker, who is protesting $1 billion in transfer pricing adjustments related to technology licenses and manufacturing arrangements between it and its Puerto Rican and Irish subsidiaries. The initial case was consolidated with: (i) a challenge by related party Boston Scientific Corp., which is challenging an $829.7 million adjustment; and (ii) another set of cases filed by an affiliate named Cardiac Pacemakers Inc. The total income adjustments for all the cases combined to $3.5 billion.

As justification for its position that it was not required to determine the true separate taxable income of each controlled taxpayer, the IRS asserted that it did not have enough information to make reliable member-specific adjustments on the basis of the information available to it. The IRS stated that it was unable to extract the information necessary to ascertain the income reported by each Guidant group member with respect to the products and transactions at issue. The IRS also stated that it was unable to determine the separate taxable income of each Guidant group member for the products and transactions at issue.

Although each Guidant group member's available financial statements encompassed all activities the entity performed and all the products it produced and sold, including those not at issue in this case, the Tax Court agreed with the IRS, finding that the taxpayers did not maintain their financial records in a manner that allowed them to readily track income and expenses by place of manufacture, and thus it was not possible to tie the income and expenses in the business unit financial statements to particular product lines. While the available information enabled the IRS to make what it considered a reliable calculation of consolidated taxable income for the Guidant group, the IRS did not believe the available information enabled it to make a sufficiently reliable calculation of member-specific adjustments for each of the Guidant group members.

The Tax Court found that the plain language of the Treasury regulation at issue clearly mandates that both consolidated and separate taxable income be determined, but that the regulation does not specifically require the IRS to determine separate taxable income contemporaneously with making a §482 adjustment. The Tax Court further reasoned that the primary principle underlying the consolidated return regime is a taxing of the true net income of the consolidated group as a whole:

Bearing the principles of the consolidated return regime in mind, we read [Treas. Reg. §] 1.482-1(f)(1)(iv) . . . to require the [IRS] to determine both [consolidated taxable income] and [separate taxable income] when making a [§] 482 adjustment with respect to income reported on a consolidated return, but also giving the [IRS] a certain latitude to decide when the determination of [separate taxable income] becomes necessary. . . . As we see it, the [IRS]'s main responsibility under the regulation [at issue] . . . 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.

Because of this underlying rationale in the regulation, the Tax Court held that the IRS's decision to defer making the true separate taxable income determination until such time when the determination is actually required is not improper as a matter of law. The Tax Court further noted that, if Guidant's interpretation were to prevail, then the IRS might not be able to make a §482 adjustment if a taxpayer consciously withheld or failed to maintain records necessary for separate taxable income adjustments.

In discussing the second issue on aggregation, the Tax Court held that the Treasury regulations allow the IRS to aggregate separate transactions when doing so provides the best means of determining the true taxable income of a controlled taxpayer. Because of this, the IRS's decision to aggregate the transactions involving tangibles, an intangible, and services in this case is a question of fact and should be resolved on the trial record.

Because the Tax Court denied Guidant's motion for summary judgement, the case will now proceed to a full trial.

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