



## US Tax Court sides with Amazon in intangibles transfer case

Global Transfer Pricing Alert 2017-008

The US Tax Court in its March 23 opinion *Amazon.com, Inc. v. Commissioner*, T.C., No. 31197-12, 148 T.C. No. 8, 3/23/17, found the IRS's approach to valuing a cost sharing buy-in payment to be arbitrary, capricious, and unreasonable.

The Tax Court specifically addressed the following three issues under the 1995 cost sharing regulations: (i) the price of a buy-in payment; (ii) the price of other intangible transfers; and (iii) the subsequent allocation of certain intangible development costs (IDCs). All three issues arose in relation to a cost sharing arrangement (CSA) that was entered into as part of a 2004 restructuring by Amazon.com Inc. (Amazon US) and its Luxembourg subsidiary. Also at issue was whether a claw-back provision contained in the CSA for stock-based compensation (SBC) was operative in light of the Tax Court's decision in *Altera Corp. v. Commissioner*, 145 T.C. 91. The years before the court were 2005 and 2006.

It should be noted that, on January 5, 2009, the IRS and Treasury redesignated the regulations at issue in the *Amazon* case as Treas. Reg. §1.482-7A, and at the same time promulgated new temporary cost sharing regulations that were designated as Treas. Reg. §1.482-7T (T.D. 9441, 74 Fed. Reg. 352). The IRS and Treasury later issued final regulations on December 22, 2011 (T.D. 9568, 76 Fed. Reg. 80090), which adopted the effective date of the temporary regulations. Therefore, the opinion of the Tax Court in *Amazon* is limited to transactions before January 5, 2009, and is not directly

applicable to cost sharing transactions that are governed by the post-2009 temporary and final regulations.

### **Buy-in payment and intangible transfers**

In this case, the IRS proposed to value the buy-in and other intangible transfers in the aggregate using a discounted cash flow analysis (DCF) with a perpetual life. The Tax Court held that the IRS's approach to valuing the intangible transfers was arbitrary, capricious, and unreasonable. Affirming its decision in *Veritas Software Corp. v. Commissioner*, 133 T.C. 297, the Tax Court rejected IRS attempts to distinguish or overrule *Veritas* and held:

- The intangibles at issue did not have a perpetual useful life;
- The buy-in payment was not "akin to a sale";
- The workforce in place, goodwill, and going concern value should be excluded when determining the buy-in payment;
- The intangibles at issue should not be valued in the aggregate; and
- The transferred website technology decayed in value over its useful life.

The Tax Court rejected the IRS's attempt to value the transferred intangibles in the aggregate. Under the aggregation principle, analyzing the combined effect of multiple transactions in the aggregate may be appropriate if combining the transactions provides the most reliable measure of an arm's length result. The Tax Court rejected the use of aggregation in this case, because such an analysis would have effectively combined: (i) preexisting intangibles, which were the subject of the buy-in; and (ii) subsequently developed intangibles, which were co-owned by the cost share participants. In addition, the Tax Court found that aggregation would combine compensable intangibles (website technology, trademarks, and customer intangibles) and non-compensable residual business assets, such as workforce in place, goodwill, and going concern value.<sup>1</sup>

The Tax Court rejected the IRS's contention that the "realistic alternatives" principle articulated in Treas. Reg. §1.482-1(f)(2)(ii)(A) supported the IRS's application of the DCF. Under the realistic alternatives principle, the commissioner of the Internal Revenue Service is authorized to consider realistic alternatives to determine if the controlled transaction is arm's length. The IRS contended that the realistic alternative for Amazon US was to keep ownership of the IP and develop it further. This view lends support to the "akin-to-a-sale" position that the IRS argued. Based on the IRS regulations, the Tax Court concluded that the realistic alternatives considered must be consistent with the form of the transaction chosen by the taxpayer. In this case, assuming that Amazon US did not enter into the cost share arrangement was not a realistic alternative to the CSA.

The Tax Court also rejected the IRS's use of a perpetual life, maintaining that this was incompatible with the CSA requirement to compensate the transferor for preexisting intangibles. The Tax Court held that the use of a perpetual life

<sup>1</sup> As the Tax Court noted, the definition of intangible property in the cost sharing regulations in effect for 2005 and 2006 is nearly identical to the definition of intangible property contained in IRC §936(h)(3)(B), which is cross-referenced in IRC §367(d).

would include subsequently developed intangibles as well as preexisting intangibles. This, according to the Tax Court, was inconsistent with the applicable 1995 cost sharing regulations.

The Tax Court determined that the comparable uncontrolled transaction (CUT) method was the most reliable method to value the intangible transfers. Both Amazon US and the IRS presented CUTs to support their theories of the case. After adjusting the CUTs:

- The court determined that the required buy-in payments for the website technology was a royalty of 3.05 percent of sales decayed over seven years and with a 3.5-year “tail” of 0.40 percent. The court based its decay function on detailed expert testimony concerning the life of Amazon US’s website technology.
- The court valued the trademarks at 0.75 percent of sales over 20 years with no decay rate. The court took the following into consideration in determining the value of the trademarks: (i) the high recognition of the trademarks in Europe at the time of transfer; (ii) the fact that the value of the trademarks over time would be dependent on the success of the Luxembourg investment in cost shared intangibles; and (iii) the Luxembourg contribution to the value of the trademarks prior to the transfer.
- Finally, the European customer information was valued at a relatively nominal amount given the churn of customers.

### **Intangible development costs**

The IRS asserted that 100 percent of the costs attributable to certain cost centers were allocable to the CSA cost pool. At trial, Amazon US established that the employees in those cost centers engaged in substantial non-IDC activities. The Tax Court agreed that less than 100 percent of those cost centers were properly allocable to the CSA cost pool.

### **Stock-based compensation costs**

The CSA executed by Amazon US and its Luxembourg subsidiary included SBC costs in the cost pool in accordance with the IRC §482 regulations governing the years at issue. Amazon US, like other taxpayers, included a provision in the CSA whereby those costs would be “clawed back” in the event the regulations were held to be invalid. However, that provision would take effect only if certain contingencies occurred, such as the regulation in question being invalidated by a “final decision in a court of law.” In *Altera Corp. v. Commissioner*, 145 T.C. 91, the Tax Court invalidated the SBC rule at issue, which was contained in Treas. Reg. §1.482-7(d)(2) (as amended in 2004).<sup>2</sup> The Tax Court’s decision was appealed to the U.S. Court of Appeals for the Ninth Circuit on February 19, 2016. Because that case remains pending on appeal, the court held the CSA’s claw-back provision was not operative by its own terms during the years at issue.

### **Conclusion**

The Tax Court in *Veritas* and *Amazon* limited its decision to issues arising under the 1995 cost sharing regulations. The

<sup>2</sup> As noted above, Treas. Reg. §1.482-7 was redesignated Treas. Reg. §1.482-7A with the promulgation of T.D. 9441, 2009-7 I.R.B. 460. The years at issue in *Amazon*, though, were 2005 and 2006. For that reason, the prior designation has been used here.

subsequent cost sharing regulations replaced the concept of a “buy-in” payment with the concept of a platform contribution transaction (i.e., any right, resources, or capabilities). The latter concept has a much more expansive definition of what is compensable compared to just the preexisting IRC §936(h)(3)(B) intangibles at issue under the 1995 regulations.

At the same time, the income method of Treas. Reg. §1.482-7(g)(4) (as amended in 2011) specifically relies on two critical concepts that were contained in the 1995 cost sharing regulations but that, as applied, were rejected by the Tax Court in *Amazon*, namely: (i) aggregated valuation; and (ii) the realistic alternatives principle.

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