



## IRS's determination to cancel Eaton's APAs was abuse of discretion

Global Transfer Pricing Alert 2017-031

The US Tax Court on July 26 held, in *Eaton Corp. v. Commissioner*,<sup>1</sup> that the determination by the Internal Revenue Service to cancel Eaton Corporation's and its US subsidiaries' (Eaton) advance pricing agreements (APAs) was an abuse of discretion. The Tax Court also held that Eaton did not transfer intangibles subject to Internal Revenue Code section 367(d) and that Eaton's bonus payments to Tractech Holdings, Inc. executives represented employee compensation and were deductible under section 162(a).

### Background

Eaton and the IRS entered into two unilateral APAs: APA1, which covered Eaton's tax years 2001 through 2005, pursuant to Rev. Proc. 96-53<sup>2</sup> and APA2, which covered Eaton's tax years 2006 through 2010, pursuant to Rev. Proc. 2004-40.<sup>3</sup>

During the tax years at issue, Eaton licensed intangible property to its Caribbean subsidiaries operating in Puerto Rico and the Dominican Republic (referred to in the opinion as the "Island plants") to manufacture breaker products,<sup>4</sup> which were then sold to Eaton's US assembly plants, and Eaton's US distribution department. Eaton's US plants manufactured a number of the component parts used by the Island plants to

<sup>1</sup> T.C. Memo. 2017-147, T.C., No. 5576-12, 7/26/17.

<sup>2</sup> Rev. Proc. 96-53, 1996-2 C.B. 375.

<sup>3</sup> Rev. Proc. 2004-40, 2004-2, C.B. 50.

<sup>4</sup> Being, circuit breaker and electrical control products.

assemble the finished breaker products, which as noted below, was not a covered transaction for APA1 or APA2.

APA1 covered three intercompany transactions: the sale of breaker products from the Island plants to Eaton, Eaton's license of intangible property to the Island plants, which the Island plants used to manufacture the breaker products, and the Island plants' cost sharing payments to Eaton. APA2 covered only the sale of breaker products from the Island plants to Eaton.

In early 2010, Eaton discovered that it had made a number of errors in its computations of the transfer pricing method (TPM) pursuant to APA1 and APA2,<sup>5</sup> and advised the IRS of such errors. Eaton subsequently corrected these errors, and filed amended APA annual reports<sup>6</sup> and amended Federal income tax returns.

In 2011, the IRS cancelled APA1, effective January 1, 2005, and APA2, effective January 1, 2006, and advised Eaton in a cancellation letter that "these cancellations are based on numerous grounds, including the failure of a critical assumption, misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the APA."

The IRS subsequently proposed transfer pricing adjustments under IRC section 482 for Eaton's tax years 2005 and 2006, based on a different TPM than had been agreed upon in the APAs. As an alternative position, the IRS determined that Eaton transferred intangible property under IRC section 367(d) for Eaton's tax year 2006. In addition, the IRS determined that Eaton was not entitled to a deduction under IRC section 162(a) in respect of certain bonus payments paid to Tractech executives in exchange for their release of claims related to any stock options, after Eaton entered into a stock purchase agreement to acquire Tractech. The IRS maintained that such payments should have been capitalized under IRC section 263.

The IRS issued Eaton a deficiency notice for approximately \$127 million in taxes and penalties, arising from an income reallocation of approximately \$369 million.

### **Scope and Standard of Review**

The Tax Court previously held in *Eaton Corp. & Subs. V. Commissioner*, 140 T.C. 410, 417 (2013), that the standard of review is whether it was an abuse of discretion for the IRS to cancel Eaton's APAs. The IRS must show that it abided by the self-imposed limitations set forth in Rev. Proc. 96-53 for APA1 and Rev. Proc. 2004-40 for APA2, and Eaton must show that the IRS's canceling the APAs was arbitrary, capricious, or without sound basis in fact.

Rev. Proc. 96-53 provides that an APA can be cancelled if the IRS determines there was a misrepresentation, mistake as to a material fact, failure to state a material fact, or lack of good-faith compliance with the terms and conditions of the APA (but not fraud, malfeasance, or disregard) in connection with the

<sup>5</sup> A number of the errors made by Eaton related to computational errors in determining the appropriate revenues and expenses attributable to the APA Covered Transactions; allocating revenue and expenses between covered and non-covered transactions.

<sup>6</sup> APA1 and APA2 required that Eaton file an annual report for each APA year, which demonstrated compliance with the APA's terms and conditions.

request for the APA, or in any subsequent submissions (including the annual report).<sup>7</sup> Material facts are facts that, if known by the IRS, would have resulted in a significantly different APA or no APA at all.<sup>8</sup> Rev. Proc. 2004-40 provides that an APA can be cancelled due to the failure of a critical assumption or due to the taxpayer's misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the APA.<sup>9</sup> Material facts include facts that, if known by the IRS, could have reasonably resulted in an APA with significantly different terms and conditions. In regards to annual reports, the IRS will consider facts as material if, for example, knowledge of the facts would have resulted in a materially different allocation of income, deductions, or credits than reported in the annual report or the failure to meet a critical assumption.<sup>10</sup>

### **Tax Court's Decision: APAs**

The Tax Court's opinion noted that the IRS's arguments in support of the cancellation of the APAs fell into two categories: (1) misrepresentations, mistakes as to a material fact, and failures to state a material fact during the APA negotiations, and (2) implementation and compliance with the APAs.

### ***APA Negotiations***

The Tax Court reviewed nine areas of the APA negotiations in terms of misrepresentations, mistakes as to a material fact, or failures to state a material fact to determine if it was an abuse of discretion for the IRS to cancel the APAs. The Tax Court concluded that none of the nine areas addressed during the APA negotiations was a ground for cancellation, and that canceling the APAs on grounds related to the APA negotiations was arbitrary. The Tax Court found that it did not see any additional material facts, mistakes of material facts, or misrepresentations that would have resulted in a significantly different APA or no APA at all. In reaching this conclusion, the Tax Court made a number of findings in its opinion, including:

- For any fact to be material, it needs to result in a significantly different APA or no APA at all. Because the TPM is the essential part of the APA, for a fact to be material, it should have an impact on the TPM.
- Either a mistake as to a material fact or a failure to state a material fact is a ground for cancellation.
- While the revenue procedures do not explain what constitutes a misrepresentation, the court looked to the Merriam-Webster's Collegiate Dictionary, which defines "misrepresent" as "to give false or misleading representation of usually with an intent to deceive or be unfair." The court noted that throughout the APA negotiations, Eaton had one position regarding the TPMs of the covered transactions, and it provided information to support this position. The IRS had ample opportunity to raise additional questions, question Eaton's position, come up with its own position, or not agree to the APAs, which it

<sup>7</sup> Rev. Proc. 96-53, sec. 11.06(1).

<sup>8</sup> *Id.*

<sup>9</sup> Rev. Proc. 2004-40, sec. 10.06(1).

<sup>10</sup> *Id.*

did not do, and the court concluded that a different viewpoint is not the same as a misrepresentation, which needed to be false or misleading, usually with the intent to deceive, and relate to the terms of the APA.

- The cancellation of an APA is a rare occurrence and should be done only when there are valid reasons that are consistent with the revenue procedures.
- A taxpayer should not be expected to provide information that is not requested and that the taxpayer reasonably believes is unnecessary. The IRS contended that it was not aware that Eaton's US assembly business earned low operating profits or incurred losses, and that it needed additional information pertaining to certain transactions, which were not covered transactions in APA1 or APA2. Eaton contended that whether the businesses outside the scope of the APA performed well or poorly had no bearing on the arm's length price for the breaker products, that the APA TPM applied only to the distribution functions, and that the entire business was not part of the covered transaction. The Tax Court found that the IRS had information regarding Eaton's other businesses and could have inquired about how the other businesses affected the proposed TPMs before agreeing to the APAs.

### ***Implementation and compliance with the terms of the APAs***

Rev. Proc. 96-53 and Rev. Proc. 2004-40 require that a taxpayer file an annual report for each taxable year covered by the APA, describing the taxpayer's actual operations for the year and demonstrating compliance with the terms and conditions of the APA. An APA may be canceled for lack of good faith compliance with the terms and conditions of the APA.<sup>11</sup>

The IRS contended that Eaton did not comply in good faith with the terms and conditions of the APAs and failed to satisfy the annual report requirements. Eaton argued that it did not fail to comply with the terms and conditions of the APA and that its implementation errors were all computational errors that did not warrant cancellation and instead it should have been allowed to correct them.

The Tax Court rejected the IRS's arguments and concluded that Eaton made good-faith efforts to comply with the terms of the APAs.

In reaching this conclusion, the Tax Court looked at each of the seven errors made by Eaton individually, and in the aggregate. Eaton argued that an error is not material if the impact had a 5 percent or less impact, which the IRS disagreed with, noting that Eaton relied on an accounting rule, and that safe harbors for accounting purposes do not create safe harbors for tax purposes. The Tax Court noted that the revenue procedures do not contain a bright-line test on whether an error is material on the basis of its size and that a 5 percent test should not be used to determine if Eaton's error warranted cancellation of the APAs; however, the size of the error may be considered, and how the error occurred should

<sup>11</sup> See Rev. Proc. 96-53, section 11.06(1) and Rev. Proc. 2004-40, section 10.06(1).

also be reviewed. The Tax Court also considered whether the impact of the errors resulted in a tax advantage to Eaton, noting that not all of the errors were in Eaton's favor.

The Tax Court concluded that Eaton's errors were computational or related to inadvertence, that they were not material, that they would not have resulted in a significantly or materially different APA, that they did not constitute a material change in the facts on which the decision to enter into the APA was made by the IRS or change the TPM or the factors that were considered during the APA process, and that they should have been addressed through appropriate adjustments, which Eaton did through the filing of the amended APA annual reports.

The Tax Court also reviewed Eaton's specific compliance with the terms of the APAs, as the IRS contended that there was a lack of compliance in the following areas: (1) book-tax differences, (2) Forms 1120 and compliance with the APAs, (3) Canadian adjustments, and (4) VISTA data. Eaton argued that it was in compliance with the terms of the APAs in these areas, and the Tax Court agreed, concluding that these four areas were not grounds for cancellation.

The Tax Court further reviewed whether there was a failure of a critical assumption, as raised by the IRS in its cancellation letter to Eaton. The cancellation letter did not specify which critical assumption had been breached, and the Tax Court found that it did not believe a critical assumption had been violated.

The final statements contained in the opinion note that the IRS had ample opportunity to walk away from the APA negotiations for both APA1 and APA2, and that while Eaton made numerous mistakes, these were inadvertent, and the IRS should not be able to use these errors as grounds for switching to a different TPM that was contemplated during the APA1 and APA2 negotiations. The Tax Court held that the cancellation of the APAs by the IRS was arbitrary and unreasonable, and did not sustain the IRS's determination to cancel the APAs.

### **Tax Court's decision: other matters**

The Tax Court also reviewed the IRS's alternative position and held that Eaton did not transfer intangibles subject to IRC section 367(d), stating that the IRS "did not specifically identify any intangible or explain the exact value of any intangibles that should be covered by section 367(d)."

Finally, the court held that Eaton's bonus payments to Tractech executives represented employee compensation and were deductible pursuant to section 162(a).

### **Observations**

Updated guidance on APAs issued by the IRS in 2015 may address a number of concerns raised by the IRS throughout this case, which is also consistent with recent developments at the OECD level.<sup>12</sup> Unlike the prior APA procedure, Rev. Proc. 2015-41 places a strong emphasis on presenting the entire

<sup>12</sup> On August 12, 2015, the IRS released Rev. Proc. 2015-41, which provides updated procedures governing APAs, and is effective for all APAs filed on or after December 30, 2015. Rev. Proc. 2015-41 updates and supersedes Rev. Proc. 2006-9, which updated and superseded Rev. Proc. 2004-40.

value chain in relation to the covered transactions.<sup>13</sup> Accordingly, a complete APA request now must include “covered issue diagrams,” which are relevant tax, legal, and management structures and the value chain relating to the covered issues. In addition, Rev. Proc. 2015-41 notes that the IRS may require, as a condition of continuing with the APA process, that the taxpayer expand the proposed scope of its APA to cover what the revenue procedure refers to “interrelated matters” to reach a resolution that is in the interest of principled, effective, and efficient tax administration.

It is anticipated that the IRS Advance Pricing and Mutual Agreement (APMA) Program will continue to focus on reviewing and understanding the entire value chain in relation to proposed covered transactions in APAs and reviewing interrelated matters to determine the potential impact on APAs. In addition, the IRS APMA Program may increase its review of taxpayers’ APA annual reports for compliance with the APA.

Overall, the Tax Court’s decision should help alleviate companies’ potential concerns after the cancellation of Eaton’s APAs, and may shed some light on standards to apply in the future.

The IRS has 90 days from the date the Tax Court formally enters its decision to appeal the decision.

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<sup>13</sup> Proposed covered transactions are referred to as proposed covered issues in Rev. Proc. 2015-41.

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