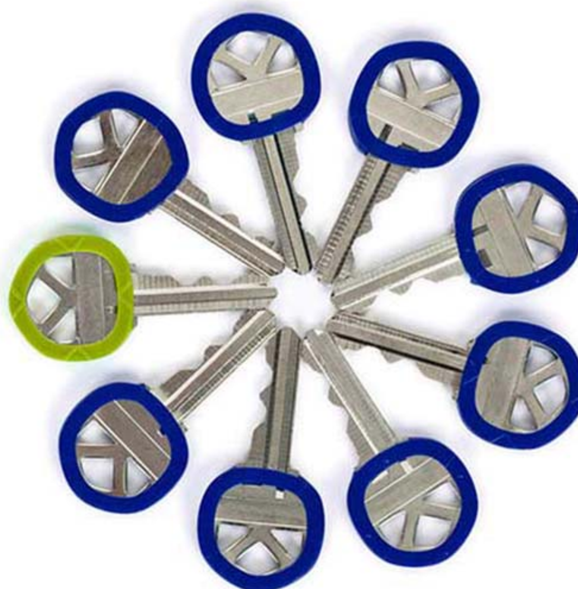

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US Tax Court sides with Amazon in intangibles transfer case

The US Tax Court in its March 23 opinion *Amazon.com, Inc. v. Comm'r*, 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

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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.[1]

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 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:
    - The high recognition of the trademarks in Europe at the time of transfer;

[1] 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).

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- 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
  - 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).[2] The Tax Court's decision was appealed to the US 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 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.

District Court Holds that Taxpayer Must File Subsequent Refund Claims In Order to Be Entitled to Amounts Collected By the IRS While Refund Suit Is Pending

On January 29, 2010, the IRS assessed air transportation excise taxes under Internal Revenue Code ("IRC") § 4261 against NetJets[3] for multiple periods in 2003 through 2009. Normally, a taxpayer must full pay its tax liabilities before it can file a refund claim (the "full-payment rule"). However, an exception exists for divisible taxes, such as excise taxes. In those cases, a taxpayer need only pay the amount of tax due on an individual transaction for each period to gain standing to challenge the entirety of the assessment. As a result, NetJets made divisible payments for each of the periods at issue and subsequently filed refund claims. The IRS denied the claims, and NetJets filed a refund suit. While the refund suit was pending, the IRS seized NetJets' overpayments in later tax years and applied them toward the excise tax assessments. NetJets did not file any subsequent refund claims for these amounts.

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[2] 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.
[3] NetJets Aviation, Inc., NetJets Large Aircraft, Inc., NetJets International, Inc., and Executive Jet Management are referred to herein collectively as "NetJets."

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On January 26, 2015, the United States District for the Southern District of Ohio determined that NetJets was not subject to the excise taxes at issue.[4] As a result, the court entered a final judgment in NetJets' favor and dismissed the refund suit, however, the judgment did not outline any specific award or provide for any tax refund amounts. Both NetJets and the United States subsequently filed motions to alter or amend the judgment, with each side disagreeing with the other side's calculation of the amount of refund due.

The United States argued that NetJets was entitled only to a refund of the divisible payments it had made prior to filing its refund claims and was not entitled to a refund of the overpayments that had been applied to the excise taxes because NetJets had not filed any refund claims for these amounts. Initially, the United States argued that NetJets had not sought the refund of the overpayments in the complaint, nor in any filing prior to the entry of the court's final judgment, and, therefore, was precluded from recovering those amounts. When NetJets countered that Fed. R. Civ. P. 54(c) provides that a final judgment should grant the relief to which a party is entitled, even if the party has not demanded that relief in its pleadings, the United States replied that Fed. R. Civ. P. 54(c) cannot trump sovereign immunity. Specifically, the United States argued that sovereign immunity has not been waived in this case because NetJets did not comply with the rules set forth in IRC § 6511, which are a prerequisite to filing a refund suit against the United States under IRC § 7422.

IRC § 6511(b)(2)(B) provides that if a refund claim is filed more than three years after the return was filed, a taxpayer's recovery is limited to the amount paid during the two years immediately preceding the filing of the claim. Under this rule, therefore, NetJets would have had to file refund claims within two years of the dates on which the IRS applied the overpayments to the outstanding excise tax liability. NetJets had not filed any such refund claims, and by the time the court entered judgment in NetJets' favor in January 2015, it was too late for NetJets to do so. Although NetJets had filed proper refund claims after making the divisible payments for each of the periods at issue, those claims had been filed before the IRS retained and applied the overpayments, and were therefore too early to reach those amounts. As a result, the United States argued, NetJets should have filed new refund claims subsequent to the application of the overpayments to the excise taxes, and while challenging its liability for any such excise tax liabilities.

NetJets argued that the court should forgo a literal interpretation of IRC § 6511(b)(2)(B) in favor of an interpretation that considered the statute's legislative history and did not reach an absurd result. Specifically, NetJets explained that the predecessor of IRC § 6511(b)(2)(B) was enacted as an accompaniment to the full-payment rule, which, as explained above, does not currently apply to excise taxes. NetJets argued that IRC § 6511(b)(2)(B) was intended to stop taxpayers from paying taxes bit by bit over a lengthy period of time and then filing a refund claim for the entire amount upon reaching full payment. It was not intended to apply to situations, like the one here, involving divisible taxes when the IRS applies overpayments to the outstanding liability after a claim for refund of those same taxes has been filed. When the predecessor to IRC § 6511(b)(2)(B) was enacted, the divisible payment rule did not exist, so, NetJets argued, this situation could not have arisen, since the taxpayer would have fully paid the tax in question, and therefore no overpayments could be applied thereto.

The court found that, while the divisible-payment rule may not have existed when the predecessor to IRC § 6511(b)(2)(B) was enacted, that section had undergone numerous revisions in the decades since that rule was first recognized by the Supreme Court, and yet the language remained unchanged. Therefore, the court concluded, if it had been Congress' intent that IRC § 6511(b)(2)(B) not apply to claims regarding divisible taxes, Congress could have communicated that intent through the language of the statute in the last fifty-seven years. Instead, IRC § 6511 continues to apply very broadly to *any* tax, and contains no exceptions. The court also found unpersuasive NetJets' argument that the United States' reading of IRC § 6511(b)(2)(B) produced an absurd result, finding that while the requirement to file multiple refund claims while a refund suit on the very tax at issue is pending might be tedious, it was not absurd. Finally, the court held that filing a refund claim does not become a superfluous task simply because the lawfulness of the underlying assessment has already been determined.

As a result, the court held that NetJets was not entitled to recover any of the overpayments that had been applied to the excise taxes for which NetJets had not timely filed a refund claim, even though the court had previously determined that NetJets was not subject to those excise taxes.

[4] *NetJets Large Aircraft, Inc., et al. v. United States*, No. 2:11-cv-1023, 2017 US Dist. LEXIS 49232 (March 21, 2017).

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Court of Appeals Affirms Tax Court Holding that a Notice of Deficiency Is Not Subject to the Administrative Procedure Act

In a recent case on appeal from the Tax Court, the Fourth Circuit upheld an IRS notice of deficiency that was issued with only a conclusory statement regarding the disallowance of a deduction.[5] QinetiQ was the successor in interest to Dominion Technology Resources, Inc. ("DTRI"), having purchased all outstanding stock of DTRI in 2008. On its income tax return for the fiscal year ending March 31, 2009, QinetiQ claimed a deduction for wages in the amount of the fair market value of stock DTRI had issued to its original shareholders in 2002. The IRS disallowed the deduction and issued a notice of deficiency stating that the IRS had determined that QinetiQ "ha[d] not established that [it was] entitled" to a deduction "under the provisions of § 83," and that QinetiQ's taxable income for the year thereby was increased by $117,777,501. The IRS did not give any further explanation for denying the tax deduction in the notice of deficiency. QinetiQ filed a petition with the Tax Court challenging the sufficiency of the notice of deficiency, and argued that the IRS failed to give a reasoned explanation for denying the deduction. The Tax Court held that the notice of deficiency provided a sufficient explanation, and QinetiQ appealed to the Fourth Circuit.

On appeal, QinetiQ again argued that the notice of deficiency was invalid because it failed to provide a reasoned explanation for the IRS' final decision, as required by the Administrative Procedure Act ("APA"). The APA authorizes district courts to review agency actions by examining the administrative record that existed at the time of the action. The Supreme Court has held that a required component of the administrative record is a "reasoned explanation for [the agency] action."[6] QinetiQ argued that this requirement of a reasoned explanation applies to a notice of deficiency because that notice is a final agency action within the meaning of the APA. As a result, QinetiQ posited, the IRS' failure to comply with this requirement rendered the notice of deficiency invalid.

The Fourth Circuit stated that QinetiQ's position failed to consider "the unique system of judicial review provided by the Internal Revenue Code for adjudication of the merits of a [notice of deficiency]." The court further explained that "[i]t is that specific body of law, rather than the more general provisions for judicial review authorized by the APA, that governs the content requirements of a [notice of deficiency]." The Fourth Circuit pointed out that, under the APA, a reviewing court is not authorized to conduct a de novo evaluation of the administrative record or reach its own conclusions regarding the subject matter that was before the agency. On the other hand, the Tax Court does conduct a de novo review of a notice of deficiency, which allows the court to consider new evidence and new issues not presented at the IRS level.

Additionally, the Fourth Circuit addressed the requirement under the APA that an agency decision be "final," and explained that this standard meant the agency "action must be one by which rights or obligations have been determined, or from which legal consequences will flow."[7] After issuing a notice of deficiency, the IRS may later assert new legal theories and allege additional deficiencies in Tax Court, and taxpayers may raise new matters that were not previously considered by the IRS during the administrative proceeding. The court explained that these fluid procedures were contrary to the reviews of final agency actions under the APA, in which the judicial review is confined to the issues raised and considered in the administrative record. As a result, the Fourth Circuit held that the APA's procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision, were not intended by Congress to be imposed on the specific procedures for a judicial review of the merits of a notice of deficiency.

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[5] *QinetiQ US Holdings, Inc. & Subsidiaries v. Comm'r*, 845 F.3d 555 (4th Cir. 2017).
[6] *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515-16 (2009).
[7] *Bennett v. Spear*, 520 U.S. 154, 178 (1997).

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IRS Office of Chief Counsel Highlights Requirement for IRS to Determine the Value of Each Property Individually to Calculate Accuracy-Related Valuation Misstatement Penalties under IRC Section 6662

In the situation presented in ILM 2017110009, dated November 4, 2016, the Taxpayer was an S corporation that operated retail stores and sold a variety of products and supplies. During each of the tax years in issue, the Taxpayer donated some products and claimed an itemized charitable deduction based on the combined fair market value of the donated products. To document the fair market value of each of the products donated, the Taxpayer included with each of its income tax returns the Form 8283, *Noncash Charitable Contributions*, and an appraisal report. The appraisal report listed and valued each product individually and also calculated the combined fair market value of all of the donated items.

The IRS examined the Taxpayer's returns for the applicable years in order to determine whether the Taxpayer had fully complied with the IRC section 170 noncash charitable contribution requirements. The IRS determined that the appraiser who prepared the appraisal report was not a qualified appraiser for the purpose of claiming the charitable contribution deduction for the Taxpayer's noncash donations and, thus, the IRS concluded that the claimed deductions should be denied. In addition, the IRS's Office of Art Appraisal Service ("AAS") selected a random statistical sample of the donated items to appraise. After comparing the values of the sample items in the AAS's appraisal with the values reported in the Taxpayer's appraisal report for the same items, the IRS determined that the values of the property were overstated by at least 200%. Apparently, by extrapolating the results of the sample, the IRS concluded that all of the donated items had values that were overstated by at least 200% and, consequently, found that the Taxpayer was liable for the 40% gross valuation misstatement penalty under IRC section 6662(h). In the alternative, the IRS concluded that the 20% substantial valuation misstatement penalty would apply, pursuant to IRC section 6662(b)(3) and (e).

The IRS Office of Appeals requested Chief Counsel's views on whether, in determining the Taxpayer's liability for the gross valuation or substantial valuation misstatement penalty under IRC section 6662, the IRS was permitted to calculate the values of multiple property items by relying on a random sample of some properties.

In the ILM, the National Office first reviewed the applicable penalty provisions in the IRC. Pursuant to IRC section 6662(b)(3), the IRS may assess a penalty of 20% of the portion of an underpayment of tax reflected in a taxpayer's return attributable to a substantial valuation misstatement. If the reported value or adjusted basis of property claimed on a return is 150% or more of the amount determined to be the correct value or adjusted basis, then, in accordance with IRC section 6662(e), there is a substantial valuation misstatement. If it is determined that the reported value or adjusted basis exceeds the correct amount by 200% or more, then the valuation misstatement is a gross valuation misstatement and, under IRC section 6662(h), the IRS may assess a penalty of 40% of the portion of an underpayment of tax reflected in a taxpayer's return that is attributable to the gross valuation misstatement.

Next, the National Office analyzed the specific language of the Treasury Regulations under IRC section 6662. In the case of multiple properties, Treas. Reg. § 1.6662-5(f)(1) provides: "The determination of whether there is a substantial or gross valuation misstatement on a return is made on a property-by-property basis." The National Office concluded that, when the IRS determines that a taxpayer has misstated the value or adjusted basis of more than one property on its return, this Treasury Regulation requires the IRS to calculate the proper value or adjusted basis of each property individually. In the situation presented, where the IRS did not appraise each property individually and, instead, based its valuation on a random statistical sample of the property items, the National Office advice suggests that the IRS may not be able to substantiate that the substantial valuation or gross valuation misstatement penalty applies because the IRS did not comply with the requirements of Treas. Reg. § 1.6662-5(f)(1) to make the determination "on a property-by-property basis."

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