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Tax Reform Seen Prompting Few Transfer Pricing Settlements

By **Molly Moses**

Law360 (February 23, 2018, 8:11 PM EST) -- The new U.S. tax on deemed repatriated offshore earnings could encourage the Internal Revenue Service to settle some pending transfer pricing cases, but it won't cause the agency to abandon most of those assessments, practitioners told Law360.

The U.S. Tax Cuts and Jobs Act, P.L. 115-97, lowered the corporate rate from 35 percent to 21 percent and introduced measures that move the U.S. in the direction of a territorial tax regime. As part of the transition to the new system, new Internal Revenue Code § 965 imposes a one-time tax on offshore earnings at dual rates — 15.5 percent for cash and cash equivalents and 8 percent for amounts other than cash.

In a transfer pricing case, the IRS reallocates to the U.S. company income the taxpayer claims was earned by an affiliate offshore. If the agency were to concede the allocation, the income would be placed back into the company's offshore earnings, subject to the repatriation tax under the new IRC § 965.

"It seems to me the IRS has every incentive, if not more incentive, to have those allocations stick because that's going to be at 35 percent," said Stephen Shay, a senior lecturer at Harvard Law School.

Because transfer pricing allocations tend to be large, the difference between 35 percent and even the higher of the dual rates could be significant, according to Scott Farmer of Morgan Lewis & Bockius LLP in Washington, D.C. Farmer said he thinks it is unlikely the IRS will stop pursuing IRC § 482 allocations and added that "the clients that I have discussed this with in some detail agree."

John Warner of Buchanan Ingersoll & Rooney PC in Washington, however, said the IRS has a somewhat diminished incentive to keep disputing transfer pricing allocations with the repatriation provision in place. While the IRS is unlikely to give up entirely on those cases, he said, "certainly the deemed repatriation narrows that gap."

One could argue that given the IRS' losing record in transfer pricing court cases, the agency could do worse than settle for a 15.5 percent or even 8 percent tax on income allocations.

In what is widely believed to be the largest tax payment the IRS has received in a transfer pricing case — decided or settled — the agency in 2006 accepted $3.4 billion from GlaxoSmithKline in a dispute where it had assessed deficiencies between $14 billion and $15 billion. The settlement of the case, which involved the pricing of pharmaceutical products with a U.K. parent, included nondocketed years, as well. A person familiar with the proceedings said the $3.4 billion reflected about 20 percent of the company's total tax exposure for docketed as well as follow-on years.

Final computations entered in December 2015 in a case involving Altera Corp. show the IRS receiving a payment of about $680,000 in tax and penalties when it had determined a liability of roughly $5.6 million. The case was costly for the IRS in another way, too — the Tax Court threw out a set of regulations mandating that stock option costs be shared in joint research and development arrangements with foreign affiliates, enabling other taxpayers with the same issue to receive favorable settlements.

In a case involving Amazon.com Inc., the agency had assessed deficiencies of more than $230 million based on its original valuation of transferred intangibles at $3.6 billion. While final tax amounts are hard to determine from the documents, a person familiar with the case said the court's findings translate to an income allocation of roughly $780 million, less than 22 percent of the IRS' determination.

But those cases don't necessarily reflect the result in transfer pricing audits as a whole.

In the case where a taxpayer accepts the IRS adjustment or the adjustment is sustained, the taxpayer ought to receive an offset from the repatriation provision, Warner said. Whether that offset reflects an 8 percent or a 15.5 percent tax is likely to be disputed, he added.

Because it would be reasonable to assume the company had paid cash to its foreign affiliate in the transaction triggering the allocation, as a taxpayer, "I would use that logical argument as a basis for saying that my § 965 liability should be reduced by 15.5 percent of the amount of the § 482 adjustment," Warner said.

The IRS, however, likely would argue for an offset of 8 percent. IRC § 965 "seems to require freezing the cash position of foreign subsidiaries" on the last day of their last taxable year beginning before Jan. 1, 2018, Warner said. That amount would not change as a result of a subsequent transfer pricing adjustment related to a year before 2018.

Therefore, Warner said, "it is conceivable that the IRS would take a literal view of the § 965 cash measurement rules to say that the § 482 adjustment merely reduces the foreign subsidiary's pre-2018 earnings and profits but does not affect the calculation of its cash position — and thus there would be a reduction of 8 percent under § 965 as a result of the § 482 adjustment."

--Editing by Tim Ruel and Neil Cohen.