King & Spalding
# Client Alert
Tax Practice Group

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## Tax Court Holds that IRS Cancellation of Advance Pricing Agreement was Abuse of Discretion

On July 26, 2017, the Tax Court issued its opinion in *Eaton Corp. v. Commissioner*, holding that the IRS's cancellation of two advance pricing agreements ("APAs") reached with Eaton Corporation ("Eaton") was "arbitrary and unreasonable," because the alleged misrepresentations upon which the IRS premised the cancellation were "inadvertent errors that do not fit the APA governing revenue procedures' definition of 'material.'"[1] The decision signals that the IRS's discretion to cancel APAs may be more limited than some, particularly the IRS, have assumed.

### Background

Section 482 of the Internal Revenue Code gives the IRS broad authority to "allocate gross income, deductions, credits, or allowances between two related corporations if the allocations are necessary either to prevent evasion of tax or clearly to reflect the income of the corporations." [2]

The correct arm's length price for an intercompany transaction under section 482 is virtually always debatable, and transfer pricing disputes typically are complex, time consuming and costly. The APA program provides a voluntary mechanism to avoid those disputes, and enables the IRS and taxpayers to resolve transfer pricing issues prospectively. Specifically, an APA is a contractual arrangement in which the taxpayer and the IRS identify relevant types of intercompany transactions, agree upon a mutually acceptable transfer pricing methodology (a "TPM") that will apply prospectively to the covered transactions, and establish a range of pricing that is to apply to the transaction.[3] Although APAs are binding on the parties, the IRS reserves the power to cancel an APA—with retroactive effect—if it determines that the APA was based on a mistake or on the taxpayer's misrepresentation or nondisclosure of a material fact during the negotiation process.[4] The IRS may also cancel an APA if the taxpayer does not abide by the TPM or fails to provide adequate reporting of its compliance with the APA. Revocation is rare: from 1991 to 2015 the IRS executed 1,511 APAs, but canceled only eleven.[5]

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**Eaton's APAs**

Eaton is the parent corporation of a group of U.S. corporations and foreign subsidiaries that are commonly controlled for purposes of section 482. Eaton and its subsidiaries manufacture electrical and industrial products. Historically, Eaton manufactured electrical circuit breakers and their components in its Puerto Rico, Dominican Republic and U.S. mainland plants. Eaton sold the breakers and parts to related subsidiaries and to unrelated third parties. The breakers were sold as standalone components or replacement parts, or were incorporated into other electrical and industrial products.

Eaton initially used the cost-plus TPM, under which "the amount charged in an intercompany sale is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions."[6] After the IRS rejected that method in an audit of Eaton's 1994 to 1997 tax years, Eaton entered into APA negotiations with the IRS, which resulted in an APA ("Eaton APA 1"), covering its tax years 2001 to 2005. Later, Eaton secured a renewal of Eaton APA 1 ("Eaton APA 2"), which covered its 2006 to 2010 tax years. The negotiation of the Eaton APAs required Eaton to provide responses to extensive due diligence requests from the IRS. Several of the members of the IRS team that negotiated Eaton APA 1 had been members of the exam team that previously audited Eaton, and were familiar with Eaton's transfer pricing practices. The Eaton APA negotiations settled upon the comparable uncontrolled price (or "CUP") method as the appropriate TPM for the breakers. The prices that resulted from application of the CUP method were to be tested against another TPM, the comparable profits method. If the CUP method's results fell outside of an agreed acceptable range of profit margins, certain price adjustments were required. Under the relevant revenue procedures, the TPM was binding on Eaton and the IRS.[7] Eaton also had a continuing duty to file annual reports with the IRS showing that it had complied with the terms and conditions of the Eaton APAs.[8]

In early 2010, Eaton discovered that over several years it had made several types of errors that resulted in incorrect transfer prices being reported in its annual reports.[9] Eaton notified the IRS of the errors, some of which did not benefit Eaton, and filed amended annual reports and tax returns. Meanwhile, the IRS performed its own review of Eaton's compliance with the APAs. In December 2011, the IRS unilaterally canceled Eaton's APAs with retroactive effect to January 1, 2005. Citing the errors Eaton had identified as well as information it claimed Eaton had not provided during the APA negotiations, the IRS explained that "[t]hese 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."[10]

**The Tax Court's Decision**

The Tax Court ostensibly applied an abuse of discretion standard to the IRS's decision to cancel Eaton's APAs. It concluded that the "relevant inquiry is whether [the IRS] abided by the self-imposed limitations set forth in the applicable revenue procedures."[11] The Tax Court then examined all of the alleged misrepresentations and omissions pertaining to the negotiations of Eaton's APAs, as well as Eaton's alleged noncompliance with those APAs.

Under the relevant revenue procedures, the IRS could cancel Eaton's APAs "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."[12] The revenue procedure governing Eaton APA 1 defined material facts as "those that, if known by the Service, would have resulted in a significantly different APA (or no APA at all)."[13] The revenue procedure applicable to Eaton APA 2 stated that facts are material if "knowledge of the facts could reasonably have resulted in an APA with significantly different terms and conditions."[14] It also provided that a misrepresentation or omission in an annual report is material if it "resulted in a materially different allocation of income, deductions, or credits than reported in the annual reports or failure to meet a critical assumption."[15]

Despite the plain language of the revenue procedures, the IRS contended at trial that "*any* misrepresentation or misstatement is sufficient on its own to show that the cancellation of the APAs was not an abuse of discretion."[16] The Tax Court rejected the IRS position, noting that "[t]he primary purpose of an APA is to reach agreement on a TPM," and applied the materiality standards set forth in the APA revenue procedures.[17]

The IRS asserted that various documents Eaton failed to provide during the APA negotiations constituted material omissions. The Tax Court found that those documents were irrelevant to the TPM. Moreover, during the IRS's due diligence it had not requested the documents, despite members of the IRS negotiating team being aware of many of them from the prior audit. The Tax Court noted that "a taxpayer should not be expected to provide information that is not requested and that the taxpayer reasonably believes is unnecessary."[18] The Tax Court concluded that Eaton and the IRS had thoroughly negotiated Eaton's APAs, and that the IRS had sufficient information to make an informed decision as to whether to enter into them. The Tax Court therefore held that the cancelation of the APAs on that ground was arbitrary.

Although Eaton conceded that its annual reports contained computational errors, it disputed their materiality. Eaton's trial expert opined that Eaton's errors resulted in a net overstatement of the transfer prices by 2.5% in one year and 0.3% in another.[19] The Tax Court agreed with Eaton that the human computational errors were inadvertent and did not demonstrate bad faith. It also noted that it was only as a result of Eaton's own internal diligence that the errors were discovered, that Eaton promptly reported the errors and provided amended annual reports, and that the errors sometimes resulted in more income being subject to U.S. taxation.[20] Ultimately, the Tax Court held that the errors did not amount to "a material change in the facts on which the decision to enter the APA was based."[21]

As an alternative argument for reallocating income among Eaton and its subsidiaries, the IRS asserted that the Eaton entities in Puerto Rico and the Dominican Republic could not have been as profitable as they were unless certain intangible property had been transferred to them from Eaton. The IRS further contended that section 367(d) required that transfer to be taxed.[22] The Tax Court rejected the argument without substantive discussion for lack of supporting evidence.

**Insights**

The Tax Court ruled in this case of first impression that "[a]n APA is a binding agreement and it should be canceled only according to the terms of the revenue procedures. It should not be canceled because of a desire to change the underlying [TPM]."[23] In concluding that "the cancellation of the APAs was arbitrary and unreasonable," the Tax Court said it applied an abuse of discretion standard, but in so doing made no mention of the deference typically afforded administrative actions.[24] In any event, the evidence was found by the Tax Court substantially favored the taxpayer and the court appears to have reached the right result. More surprising would have been a contrary decision holding in favor of the IRS invalidating Eaton's APAs based on "any misrepresentation or misstatement," even if they were not material. That also invariably would have damaged taxpayer confidence in the APA program, because if the IRS could cancel any APA for minor errors, particularly those where, with the benefit of hindsight, the IRS determined that it would have preferred different terms, few would have had reason to trust the program going forward.

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[1] *Eaton Corp. v. Comm'r*, T.C. Memo. 2017-147, 193 (July 26, 2017).
[2] *Id.* at 120-21; *see* 26 U.S.C. §482.
[3] *See* IRS Announcement 2000-35, 2000-1 C.B. 922.
[4] *See* Rev. Proc. 96-53, 1996-2 C.B. 375; Rev. Proc. 2004-40, 2004-2 C.B. 50.
[5] IRS Announcement 2016-2, 2016-16 I.R.B. 589, 591-92.
[6] *Eaton Corp.*, T.C. Memo. 2017-147, at 34.
[77] *See* Rev. Proc. 96-53, § 10.01, 1996-2 C.B. at 383; Rev. Proc. 2004-40, §§ 2.04, 9.01, 2004-2 C.B. at 51, 61.
[8] *See* Rev. Proc. 96-53, § 11.01(1), 1996-2 C.B. at 383; Rev. Proc. 2004-40, § 10.01(1), 2004-2 C.B. at 61.
[9] *Eaton Corp.*, T.C. Memo. 2017-147, at 96.
[10] *Id.* at 40, 134.
[11] *Id*. at 131.
[12] *See* Rev. Proc. 2004-40, § 10.06(1).
[13] *See* Rev. Proc. 96-53, § 11.06(1).
[14] *Id.*
[15] *Eaton Corp.*, T.C. Memo. 2017-147, at 177 (citing Rev. Proc. 2004-40, § 10.06(1)).
[16] *Id*. at 158 (emphasis added).
[17] *Id*. at 152-53.
[18] *Id*., at 155.
[19] *Id*. at 164.
[20] *Id*. at 175-76.
[21] *Id*. at 178.
[22] *Id.* at 194.
[23] *Id.* at 193.
[24] *Id.* at 193. *See generally*, *Epsilon Elecs., Inc. v. United States Dep't of the Treasury*, 857 F.3d 913, 918 (2017) ("As the Administrative Procedure Act requires, our review is 'highly deferential' to the agency, meaning we may set aside [its] action 'only if it is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.' Under that standard, we will uphold agency findings that are supported by substantial evidence, even if we might have reached a different conclusion in the first instance.") (citations omitted).