



Eaton Gets a Win in Recent Advance Pricing Agreement Court Case

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On October 28, 2019, the U.S. Tax Court released a supplemental opinion regarding Eaton Corporation's recent win in *Eaton Corp. & Subs. V. Commissioner, T.C. Memo 2017*.

Background

The Eaton Corporation ("Eaton") is the parent of a multinational group that manufactures electrical and industrial products. The Internal Revenue Service ("IRS") audited Eaton's 1995 to 1997 tax returns, rejecting Eaton's proposal to use the comparable uncontrolled price ("CUP") for its transfer pricing method ("TPM"). A settlement was reached and as a part of the settlement, Eaton applied for its first unilateral Advance Pricing Agreement ("APA I") in 2002. In 2004, the IRS and Eaton reached an agreement on APA I, which covered Eaton's 2001 to 2005 tax years. APA I covered intercompany transactions between Eaton and its related parties, including the sale of breaker products to Eaton from its manufacturing entities, the licensing of intellectual property ("IP") by Eaton to its manufacturing entities and the manufacturing entities' cost-sharing arrangement with Eaton.

In 2005, Eaton renewed APA I (referred to as "APA II"), which covered Eaton's 2006 to 2010 tax years. APA II stated that if Eaton complied with the APA terms, then the IRS would not propose any section 482 adjustments; one of the key reasons for entering an APA. However, if Eaton failed to comply with the terms, then the IRS could propose Section 482 adjustments if appropriate or cancel the APA. In early 2010, Eaton had discovered it had made computational errors in the APA TPM calculations and in its tax reporting. The APA multiplier was miscalculated and resulted in an incorrect transfer price, which ultimately reflected in Eaton's tax returns. Additionally, there were errors that affected the transfer price computations made under APA II. By October 2010, Eaton had corrected these errors, which amended both its APA annual reports and federal income tax returns. The IRS, however, rejected these self-corrections.

In December 2011, the IRS took an unexpected position and cancelled both APAs. The IRS contended that the decision to cancel Eaton's APAs was on the basis that Eaton "did not comply in good faith with the terms and conditions of either APA I or APA II and failed to satisfy the APA annual reporting requirements." [1] Due to the cancellation, the IRS reviewed Eaton's transfer pricing and determined that a Section 482 adjustment was necessary. The adjustments resulted in a notice of deficiency determining that Eaton owed \$19.7 million and \$55.3 million for the tax years 2005 and 2006, respectively. [2]

Tax Court Ruling

In *Eaton Corp. & Subs. V. Commissioner, T.C. Memo 2017-147*, the IRS's decision to cancel Eaton's APAs was ruled an abuse of discretion. From 1991 to 2015, only 11 out of 1,511 executed APAs were cancelled; therefore, this case was placed under scrutiny

after the highly unusual sequence of events.[3] The U.S. Tax Court ruled Eaton's errors did not warrant the cancellation of the APAs and that Eaton was in fact compliant with the terms of the APA. The U.S. Tax Court ruled that Eaton's errors were "not enough to conclude the aggregate of the errors resulted in a mistake as to a material fact, a lack of good faith compliance, or failure to meet a critical assumption" and that these miscalculations were inadvertent as "the errors in the aggregate did not consistently favor the petitioner, and the error amounts were inconsistent." [4]

Following the ruling that the cancellation of the APAs was an abuse of discretion, the next step was addressing Eaton's penalty liabilities. To address this issue, the IRS and Eaton were required to submit computations for the entry of decision under Tax Court Rule 155. The IRS's position was that the computations should include 40 percent penalties pursuant to the Internal Revenue Code ("IRC") Section 6662(h). Eaton's position was that there were no adjustments pursuant to IRC Section 482 and thus the referenced penalty regime was also not required.

On October 22, 2018, there was a hearing in which both parties informed the Court they had reached an agreement on certain computations, however the Court needed to rule on whether penalties applied. The IRS claimed the cancellation of the APAs necessitated Section 482 adjustments and penalties would apply as a result. Eaton contended that its corrections did not create net Section 482 adjustments and no penalties should apply. To determine whether there were net Section 482 adjustments, the Court addressed the applicable code sections and regulations.

In a supplemental opinion released in October 2019, the U.S. Tax Court reasoned that the IRS's cancellation of Eaton's APAs directly resulted in the deficiencies and the IRS then adjusted Eaton's income under Section 482 and issued a deficiency notice. Eaton could not have altered the transfer pricing methodology since the APAs were still effective for the years in issue. The APAs were still effective due to the fact that the case only addressed an abuse of discretion to cancel the APAs and not an abuse of discretion regarding a Section 482 allocation.

The opinion held by the U.S. Tax Court was that no adjustments were made under Section 482; therefore, Eaton is not liable for penalties because the APAs were still in effect after the U.S. Tax Court's determination. As such, there was "no allocation of income and deductions under [S]ection 482, and no net increase in taxable income resulting from [S]ection 482 adjustments". [5]

A&M Taxand Says

This case could raise concerns regarding the compliance certainties of APAs, and whether APAs are worthwhile considering the process of obtaining an APA is time-consuming and expensive. Even with these concerns, and the number of APA cases received by the IRS has only grown since 1991.[6] Tax authorities can expect the number of APAs to continue to increase as APAs become "more practical, affordable, and available to more taxpayers." This is especially true as the international tax landscape becomes more complicated and companies seek greater certainty in their tax positions. Although APA cancellations are a rare event, as evidenced by the statistics noted earlier, there is a high likelihood issues like this will arise again. As such, companies should be diligent in reviewing their APAs annually to ensure compliance of APA terms.

One may assume that APAs have a high degree of certainty since they have been subject to careful review by the IRS. However, because these agreements are prepared by various tax personnel, there is a likely chance of finding human errors upon review. In this case, the errors managed to pass Eaton's internal and even the IRS's external reviews. Fortunately, the responsiveness and cooperation of Eaton after the discovery of computational errors factored into the court's favorable ruling. Therefore, it is crucial to be proactive in reviewing APAs annually and reporting any errors to the tax authorities promptly. In this era of increased suspicion of tax avoidance, even inadvertent mistakes can result in costly and time-consuming court battles.

[1] *Eaton Corp. & Subs. V. Commissioner*, T.C. Memo 2017-147., page 2.

[2] *Eaton Corp. & Subs. V. Commissioner*, T.C. Memo 2017-147., page 113.

[3] *Eaton Corp. & Subs. V. Commissioner*, T.C. Memo 2017-147., page 121.

[4] *Eaton Corp. & Subs. V. Commissioner*, T.C. Memo 2017-147., page 179.

[5] *Eaton Corporation and Subsidiaries v. Commr.* T.C. Memo, T.C. No. 6.

IRS Transfer Pricing Model...Is a Residual Profit Split in Store for Everyone?

The IRS Advance Pricing and Mutual Agreement (APMA) program announced recently that it has developed a “functional cost diagnostic model” (“FCDM”), an Excel-based program, to facilitate its review of certain Advance Pricing Agreement (APA) requests.

Survey of Transfer Pricing Issues in U.S. Business Restructurings

Business restructurings achieve economic benefits through a broad array of strategies. Cost savings and operational improvements are often key drivers. The primary mechanisms used to achieve the company's goals involve the redeployment of functions, assets or risks. Therefore, a restructuring exercise may offer significant tax planning opportunities through transfer pricing.

So the IRS is Auditing your Transfer Pricing...

Don't panic, the IRS has laid out a process for examining transfer pricing in its Transfer Pricing Examination Process (TPEP), Publication 5300.

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