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Amazon Moves Toward Trial in High-Profile Case Challenging IRS Income Method for Valuing Intangibles

Amazon.com Inc.'s transfer pricing dispute with the Internal Revenue Service goes to trial Nov. 3 in Seattle. A central issue in the case is the valuation of intangibles under a cost sharing arrangement between the U.S. company and its European subsidiary. Amazon takes the position that the discounted cash flow method used by the IRS was invalidated by the U.S. Tax Court in Veritas Software Corp. v. Comr. *In this article, practitioners discuss the dispute over valuation and the agency's prospects for arriving at a more favorable ruling under different facts.*

Amazon.com Inc. goes to trial in U.S. Tax Court Nov. 3 in a highly watched transfer pricing dispute that has the potential to change the ground game for valuing outbound intangibles.

Amazon is challenging a $2.2 billion transfer pricing adjustment related to a cost sharing arrangement between it and a Luxembourg affiliate that took over its European operations in 2004. At stake for the Internet retailer is $234 million in back taxes for fiscal year 2005-06, but an IRS victory could cost the company far more—up to $1.5 billion over a seven-year period, according to the company's most recent quarterly report.

Billions more hang in the balance for the IRS—and U.S. taxpayers—if a ruling for the agency persuades other companies to settle similar issues on terms more favorable to the government.

Right now, the taxpayer has the upper hand, thanks to the smackdown delivered to the IRS by the tax court in *Veritas Software Corp. v. Comr.*, 133 T.C. 297 (2009).

Veritas is the only case litigated to date on the issue of buy-in payments for cost sharing arrangements. In *Veritas* , the court found that the IRS was arbitrary and capricious in applying its discounted cash-flow analysis (18 *Transfer Pricing Report* 843, 12/17/09).

Up for debate is whether the court rejected the income method outright or merely the IRS's application of it. Amazon is challenging its transfer pricing adjustment in part on the ground that the IRS's economist, Daniel Frisch, relied on ''the discounted cash flow method previously rejected by this Court in *Veritas*.''

Since that decision in 2009, taxpayers considering the hazards of litigation have enjoyed a strong negotiating position in the Office of IRS Appeals (22 *Transfer Pricing Report* 355, 7/25/13).

Potential for Change

Amazon has the potential to change that, though the dollar impact could be limited, according to Neal Kochman of Caplin & Drysdale in Washington, D.C.

Kochman noted that *Amazon*, because it concerns tax years 2005-06, is governed by cost sharing regulations that have since been revised. So it is unclear whether an adverse ruling to Amazon would have broad implications for other taxpayers.

''My understanding is that most of the inventory of buy-in cases under the old regulations have worked their way through the system,'' Kochman said. ''At one time there was information that there were 100 buy-in cases that were working their way through Exam and Appeals, and only a small number made it to court.''

Now it appears that many of those cases have been resolved, he said.

However, the IRS maintains that the temporary cost sharing regulations issued in late 2008—and finalized in December 2011—serve merely to clarify regulations that were in place in the years at issue in *Amazon* and *Veritas*. Given that position, the IRS could conclude that a ruling on the old regulations also would apply to the new.

The key distinction is that the old regulations did not specify the use of an income method for valuing the buy-in payment in a cost sharing arrangement, Kochman noted; the new regulations do.

Economist John Hatch of Transfer Pricing Associates in Washington, D.C., told Bloomberg BNA that *Amazon* ''has a bearing on any open audits from that era, but it also probably solidifies the issues.''

Hatch served as the IRS's expert witness in *Veritas*.

"I would be very surprised if the two methodologies offered by the opposing sides—the IRS expert and Amazon's expert—differ in any fundamental way from the opposing models in the *Veritas* case," he said.

"So you'll see a case that is essentially retrying *Veritas* in terms of the economic approaches from both sides. It is interesting to me from that standpoint," he said.

Facts at Issue

Hatch noted that the IRS chose not to appeal *Veritas* but issued an "action on decision" calling the court's ruling erroneous and explaining why it would continue to litigate cases under the cost sharing regulation (19 *Transfer Pricing Report* 793, 11/18/10).

The fact that the agency is pressing the same issue under the old regulations with a different taxpayer says that the IRS does not believe the issue was settled by *Veritas*, Hatch noted.

As in *Veritas*, the issue in *Amazon* is the best method for valuing transferred intangibles under a cost sharing arrangement.

One question is whether the facts and circumstances of *Amazon* will allow the IRS to make a more persuasive argument this time around.

"Everyone talks about how these cases are fact-specific—and that is true," Hatch said. However, he added, "facts don't necessarily dictate one method over the other." Rather, the facts affect how each method is applied.

"For example, there is no set of facts specific to *Veritas* that would call for the 'taxpayer' model in that case, while a different set of facts would call for the 'IRS' model in another case," he said.

In *Amazon*, as in *Veritas*, taxpayer and tax agency came to the court with radically different numbers.

In *Amazon*, the IRS charged that the company grossly undervalued intangibles transferred to its affiliate in Luxembourg and undercharged the affiliate for its share in the cost sharing arrangement. Amazon valued the transferred intangibles at $216 million; the IRS claims they were actually worth $3.6 billion.

The difference in magnitude is similar to *Veritas*, Hatch said, where the taxpayer estimated intangibles valued at between $94 million and $315 million—and the IRS initially determined that they were worth $2.5 billion.

Useful Life

"The key methodological distinction and hurdle the IRS has to get over is the concept that the useful life of the intangibles should determine the forecast horizon for the buy-in amount," Hatch said.

According to court documents, Deloitte conducted an analysis on which Amazon based its payments. In its analysis, Deloitte relied on a useful life of seven years and the assumption that the underlying intangibles would decline in value over time if not maintained.

The IRS approach presumes that the rights to a cost sharing agreement last forever, Hatch said.

"Typically that is what you see—there is no useful life that is pertinent, because you are valuing a contract that grants rights into perpetuity—and the value of those rights is measured by cash flow," he said. "The contractual rights themselves are an intangible asset, and if the contract lasts forever, and is anticipated to yield income forever, the valuation has to consider income in all such periods."

This was the position taken by the IRS in *Veritas* and for which U.S. Tax Court Judge Maurice Foley castigated the agency. Foley concluded that the IRS had improperly valued the buy-in payment in the cost sharing arrangement between Veritas Software Corp. and its Irish subsidiary, criticizing the IRS for its handling of its position and excoriating Hatch for his testimony during trial.

In particular, Foley took issue with the fact that the IRS changed its valuation of the buy-in from $2.5 billion to $1.675 billion with no apparent explanation (18 *Transfer Pricing Report* 844, 12/17/09).

Arbitrary and Capricious?

Foley ruled that the adjustments made by the IRS under its income method were arbitrary and capricious; the comparable uncontrolled transaction (CUT) method employed by the taxpayer led to a more reasonable result, he said.

In its action on decision of November 2010, the IRS charged that Foley erred on the facts and law. According to Foley's opinion, the IRS said, preexisting technology has no ongoing R&D value. Nor did the judge attribute the value of the technology developed under Veritas's cost sharing arrangement to any preexisting technology (19 *Transfer Pricing Report* 793, 11/18/10).

Similarly, Foley ruled that the marketing contributions of Veritas to its Irish affiliate had no significant value, but rather that Veritas Ireland's marketing success was attributable to a "newly-hired sales manager, aggressive salesmanship and savvy marketing."

The IRS countered that "the facts as found by the Court would remove the underpinnings of the Service's valuation."

The unanswered question in *Veritas* is how Foley came to that finding. Because the full record is sealed, all testimony and supporting exhibits, as well as Foley's questioning of fact witnesses and experts, are blocked from public review.

A telling element in the decision is Foley's statement that the IRS and the taxpayer had stipulated that a research and development agreement (RDA) between Veritas U.S. and Veritas Ireland "was at arm's length."

"In essence," Foley wrote, "respondent's determination began to unravel with the parties' pretrial stipulations of settled issues. After the parties' settlement relating to the arm's-length value of the RDA, as a practical and legal matter respondent was forced to justify the $1.675 billion allocation by reference only to the preexisting intangibles. As discussed herein, he simply could not. Respondent, in a futile attempt to escape this dilemma, ignored the parties' settlement relating to the RDA."

Why the IRS would agree to such a stipulation is unclear, because doing so would have gutted its case. The AOD seems to suggest that the agency made no such concession. Without access to the record, however, it is impossible to know whether the IRS actually stipulated that the RDA was at arm's length or whether Foley, in fact, misunderstood the stipulations.

The AOD is silent on that question.

The record in *Amazon* will be more transparent. Even though a protective order is in place, presiding Judge Albert G. Lauber has provided for the release of

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redacted transcripts of key testimony following the trial. (See the related story and the order in this issue)

Common Valuation Method

Although the court in *Veritas* noted that the income method was not specified in IRS regulations before 2009, the method has long been familiar to Amazon founder Jeff Bezos, according to the IRS's expert in *Amazon*. In his report, Frisch noted that Bezos, in a 1997 letter to Amazon shareholders, said that when forced to choose ''between optimizing the appearance of our GAAP accounting and maximizing the present value of cash flows, we'll take the cash flows.''

Economist Patrick Breslin of Bates White Consulting in Washington, D.C., told Bloomberg BNA it is clear that a number of taxpayers and practitioners think the decision in *Veritas* was a rejection of the income method itself.

''But the present value of income streams is how you price many things in a market economy, at least implicitly,'' he said. ''It explains the value of a share of stock, for example. At arm's length, income methods like the discounted cash flow are commonly applied explicitly. Business decisions are made daily using these methods.''

Kochman agreed.

''It is crazy to me that the income method would ever be challenged because it is used by businesses for valuation all the time,'' he said.

Useful Life

An essential argument for Amazon will be that the transferred intangibles had a limited life of seven years and that they ''decayed in value'' over time.

According to the company, one critical element of the intangibles—the software supporting Amazon's website for its European operations—was in a ''fragile'' state when the company established its Luxembourg subsidiary in 2004. Brian Valentine, retired senior vice president for Amazon's electronic commerce platform, testified to that effect in a closed hearing Oct. 24 (23 *Transfer Pricing Report* 704, 10/2/14).

According to Hatch, however, the argument that R&D would stop—and the underlying technology would degrade—''does not fly'' in arm's-length transactions.

''If it truly were a logic that held muster in arm's-length negotiations, you would see acquisitions in which the price is determined by a similar method—but you never, never see that,'' he said.

Every business acquisition he has seen, Hatch said, has been valued under a model consistent with the method he used in *Veritas*—a discounted cash flow or income approach.

''I have reasons to look at a lot of acquisitions and prices paid in a lot of acquisitions, and I've never seen a method used with a declining royalty,'' he said. ''There is only one place in the world where you ever see that—in transfer pricing cost sharing buy-in valuations.''

Bundled Intangibles

In contrast to Veritas, a software company with a limited global market, Amazon is a massive multinational retailer with a strong brand name and the intellectual property to go with it. Even so, Breslin said, discussion of ''useful life'' is a distraction in both cases. ''Assumptions about useful life usually relate to one individual IP element, like software code, in isolation without any further development,'' he said.

''What I see in the list of transferred intangibles—trademarks, copyrights, patents and trade secrets—is a bundle of IP elements that must operate collectively to be commercially successful. Software and websites are the same in certain regards—you don't buy software or visit e-commerce sites without an understanding that they are constantly updated, maintained and improved to enhance the experience of paying customers. The idea that commercially successful software expires is a non-reality.''

At arm's length, Breslin said, a licensee of software does not need to consider how much of the value relates to patents versus trade secrets or copyrighted code, or ''some abstract notion of their useful lives in isolation without ongoing development.''

Thus, he said, ''efforts to separate, define and value individual elements that operate and are transacted collectively distracts from the 'real valuation question.' ''

According to Breslin, the ''important question isn't 'What is it?' It's 'What is it worth?' '' The latter, he said, is the arm's-length question independent parties agree on.

''In R&D cost sharing, most of the preexisting intangible value comes from whoever has the right to develop and change the original product or service. Research and developmental rights are vigorously protected and they are the key intangibles transferred with these buy-ins. Without development rights, you cannot do research and development, and an R&D cost sharing agreement has no purpose or meaning.''

Prospects for Reversing *Veritas*

Whether in *Amazon* the IRS can achieve a full reversal of *Veritas* —through a ruling that overtly affirms the income method—will depend on a number of factors, including the distinct facts and circumstances of the case.

As in any transfer pricing case, the precedential value will hinge on how broadly or narrowly the court rules.

''You have facts and you have law,'' Kochman said.

Some of the elements that tripped up the IRS in *Veritas*, he noted, are not present in *Amazon*—such as a dispute over the use of ''make or sell'' rights.

''Make or sell rights isn't an issue because they were not licensing website rights,'' he said.

The worst outcome for the IRS would be a ruling that invalidates the discounted cash flow method altogether—though Kochman does not think that is likely.

However, he said, ''a key element of the decision would be the judge's view on perpetual life versus the limited life approach taken by Deloitte and taxpayers in general.''

One result of Lauber's decision should be to reveal more details about the methods used by both parties, Kochman said.

''The IRS approach is to essentially value the business and then carve out from the value of the business returns to routine activities, and then take the position that everything that is left is attributable to the intangibles,'' he said. ''The Deloitte approach is more a

build-up approach where you separately attempt to value the intangibles.''

The vast difference between the results may be owing to a ''disconnect as to what is being valued,'' he said. So it is possible that the court could affirm the IRS's method but take issue with the way it was applied.

Cost Accounting Issue

One key issue in *Amazon* is that the company's cost accounting system at the time did not specifically segregate intangible development costs (IDCs) from other operating costs. Rather, the company developed a formula that it used to allocate to IDCs a portion of costs from scores of cost centers—tracked in six broad categories: cost of sales, fulfillment, marketing, technology and content (T&C), general and administrative, and ''other.''

Amazon is challenging the IRS's position that 100 percent of T&C costs are IDCs. If it wins on that point, Amazon could see a reduction in the assessment. To get there, however, Amazon must show that the T&C category contains ''nontrivial costs that are properly characterized as something other than IDCs'' (23 *Transfer Pricing Report* 503, 8/7/14).

Said Kochman, ''If the decision ended up coming out that the income method was the best method and they end up carving back from that and making some changes to the assumptions and coming out with a different valuation, that to me would be, if not a complete victory, a partial victory for the IRS.''

Another result of the case, he said, could be a ruling by the court that it is appropriate to use the income method for valuation under Regs. §1.482-4, which covers valuation of intangibles generally. He noted that the 2008 revisions to the regulations focused on cost sharing under Regs. §1.482-7. No changes were made to Regs. §1.482-4.

''It could very well tell you something very significant about the 'dash four' rules and whether it is legitimate to use the income method to do intangible valuations'' under those rules, Kochman said. ''That might be more significant than what it says about cost sharing itself.''

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☐ *Amazon's trial is scheduled to take place starting at 10 a.m. on Monday, Nov. 3, in courtroom 18-206B, 18th floor, at the U.S. District Court, U.S. Courthouse, 700 Stewart Street, Seattle. Portions of the trial, including opening arguments and fact witness testimony, will be closed to the public.*

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