

The Future of Transfer Pricing

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In this article, the authors review a new educational outreach program for students interested in pursuing transfer pricing careers, with in-house corporate tax and transfer pricing leaders serving as the students' mentors.

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The forecast for the future of transfer pricing as a technical discipline is partly cloudy. The arm's-length principle is in retreat. An agreement on a global minimum tax that would substantially diminish opportunities for tax rate arbitrage is close at hand.

The forecast for the future of the transfer pricing profession, however, is increasingly bright. Law and economics graduates continue to flock to the field, bringing an intuitive understanding of digital business models as well as keen analytical skills. They have increasingly elected to take additional courses to specialize in

transfer pricing or international tax. The next generation of transfer pricing professionals is more diverse in terms of education, experience, and perspective as well as ethnicity, race, religion, and sex — and more technically savvy than any that preceded it. The only gap that some new graduates have is a meaningful understanding of how the large multinationals (that will become their clients) operate their internal tax and transfer pricing functions.

Until now.

In fall 2020 the American Bar Association Section of Taxation's Transfer Pricing Committee launched an educational outreach program called "Transfer Pricing: From Classroom to Boardroom" (TP C2B), a first-of-its-kind curated mentorship program that pairs motivated law and graduate taxation and economics students interested in pursuing transfer pricing careers with in-house corporate tax and transfer pricing leaders. The program's broad goal is to educate and nurture a diverse and well-rounded next generation of transfer pricing professionals by providing opportunities for real-world grounding alongside classroom studies. For students, a structured look into how transfer pricing policies are designed and administered provides a balanced and informed view of a multinational corporation's priorities and operations. For corporate mentors, the program offers an opportunity to share wisdom and experience and thereby enhance the transfer pricing profession.

The transfer pricing committee recruited six mentor-mentee pairs for the first-year pilot program, roughly running from October 2020 through May 2021. The program was designed to culminate in a capstone exercise with presentations made by mentees on a cutting-edge transfer pricing topic. The committee invited the mentors, screened the mentees, matched them up, and waited to see what would happen.

The experiment succeeded. The mentees had enriching and unique opportunities to learn about transfer pricing practices in major multinationals. The mentors enjoyed sharing their “inside” perspective and teaching students the art of applied transfer pricing. Despite their demanding in-house roles, the mentors gave generously of their time and knowledge, meeting regularly with their mentees every two to four weeks throughout the academic year to discuss topics ranging from operational transfer pricing to court decisions and their application to practice, to how a tax department operates and interfaces with other corporate stakeholders, to the students’ career paths and interests. The mentors went above and beyond — they deserve not only our gratitude but also public recognition for their contributions.

The TP C2B mentors for fiscal 2020-2021 include Liz Chien of Protocol Labs Inc., formerly Ripple Labs Inc.; Sahar Gaya of KPMG, formerly with Glencore; David Paul of American Honda Motor Co. Inc.; Joel Wilpitz of Sazerac Company Inc., formerly with The Kraft Heinz Company; and Terri Ziacik of Microsoft.

Kudos are also in order for our TP C2B mentees: Marin Dell of University of Florida Fredric G. Levin College of Law (LLM), Hannah Karraker of University of San Diego School of Law (JD/LLM), Cory Prewit of Texas A&M University School of Law (JD), Lukens Rivil of University of Florida Fredric G. Levin College of Law (LLM), Franklin Shen of New York University School of Law (JD), and Suzanne Suttles of Texas A&M University School of Law (JD).

The 2021 TP C2B program culminated in a capstone exercise held in conjunction with the ABA Section of Taxation’s May meeting. Initially an interactive role-play was planned — a mock IRS Appeals hearing — during which the mentees would leverage both their knowledge of transfer pricing concepts acquired in the classroom and their understanding of corporate transfer pricing practice gained through the mentoring relationships, followed by a networking reception. When the May meeting went virtual, it was rebooted with Plan B: a case study of the Tax Court’s 2017 decision in *Amazon*.¹

¹ *Amazon.com v. Commissioner*, 934 F.3d 976 (2019).

The mentees worked in teams of two, and through dialogue with their mentors and the study of publicly available materials, they developed analyses of three questions provided by the committee.

On May 13 the mentee pairs presented their analyses and responded on the fly to questions from an expert panel and the audience of tax section members assembled via Zoom. And, wow, were the mentees ever impressive!²

Below we present the three mentee teams’ original, copy-edited summaries of their capstone presentations, followed by a look ahead to the next year of TP C2B.

Amazon and the TCJA — Cory Prewit and Marin Dell

Amazon involved pre-Tax Cuts and Jobs Act years. Do you believe the case would have been decided differently if post-2017 law — in particular, new section 367(d)(4) — had applied, and if so, how and why?

Amazon is undoubtedly an interesting case involving the transfer of intangibles from a parent company to a subsidiary. The IRS determined that Amazon.com Inc. had a federal income tax deficiency for the 2005 and 2006 tax years arising from unreported income stemming from a transfer of intellectual property to its European subsidiary (AEHT). The Tax Court held that Amazon’s calculated buy-in payments for this transfer were appropriate, and that the IRS was incorrect in its calculations for the deficiency notice. This holding was ultimately upheld by the Ninth Circuit.³

Because the tax years in question are pre-2017, and perhaps more importantly pre-TCJA, the case almost certainly would have turned out differently had the TCJA applied to the years at issue. In particular, the IRS would have had firmer legal ground to stand on if it had been able to rely

² Many, many thanks to our designated experts — Peter Barnes, lately of the Duke University Law and Business schools, and David Bowen, of the University of San Diego School of Law — for shepherding the mentees through the thicket of cost sharing and sharing their wisdom on the case.

³ *Amazon*, 934 F.3d 976.

on section 367(d)(4). However, section 367(d)(4) would likely still not have captured all the applicable IP that was transferred from Amazon to AEHT. Further, the issue of valuing some of these intangibles will likely need to be resolved by the courts or further legislation.

The enumerated list of intangibles likely would have captured many of the intangibles at issue in *Amazon*. Section 367(d)(4)(f), which covers “goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment),” would have likely allowed the IRS to properly bring in goodwill and going concern value, which were at issue in *Amazon*. However, several other areas of IP at issue would still likely be left out despite the catchall provision in section 367(d)(4)(g).

As stated in *Amazon*, the “culture of innovation” at Amazon was invaluable to the company. From Amazon’s inception through today, the company has constantly innovated. Its rapidly changing software was developed quickly and built up a lot of “technical debt,” which reduced the useful life of its software. It isn’t entirely clear that the IRS would be able to rely on the catchall provision in section 367(d)(4)(g) to bring this “culture of innovation” into a buy-in agreement for a transfer. It is also unclear how much of Amazon’s culture of innovation was transferred to AEHT and how much was independently created by the European subsidiary. As stated in the Ninth Circuit’s opinion, Amazon’s European subsidiary had to constantly innovate to meet the cultural expectations of the various countries in which it operated.⁴

Valuation of intangibles — such as a “culture of innovation” — isn’t neatly addressed by the new sections created by the TCJA. As stated in *Amazon*, the culture of innovation would likely fall under the enterprise valuation of a business. Enterprise valuation items aren’t IP and don’t have “substantial value independent of the services of any individual.”⁵ In *Amazon*, the court held that these items wouldn’t be included in the

buy-in payments. It isn’t entirely clear that these items have been brought under the umbrella of IP as defined in section 367. This area will need to be further defined by the courts as well as new legislation and regulations.

If *Amazon* were decided today for post-TCJA tax years, the court likely would have decided differently. Several IP transfer items that were excluded from the buy-in payment almost certainly aren’t captured by the addition of section 367(d)(4). However, other potential IP items — like Amazon’s culture of innovation — aren’t covered by the code, and the proper method for valuing them is unclear.

Realistic Alternatives — Lukens Rivil and Suzanne Suttles

Consider the Tax Court’s discussion of “realistic alternatives” in *Amazon* in light of reg. section 1.482-1(f)(2)(ii), the sentence added to section 482 by the TCJA, and economic principles. What is the Tax Court’s interpretation of “realistic alternatives” and how the IRS should consider them, and is that interpretation consistent with sound economic principles?

The Tax Court’s Interpretation

In *Amazon*,⁶ the IRS defended its principal valuation expert’s approach under the realistic alternatives principle (RAP) and argued that Amazon had an available realistic alternative: the continued ownership of all its intangibles in the United States. The IRS urged that if dealing with an unrelated party, Amazon would have preferred that alternative to a cost-sharing arrangement that would give a competitor access to its “crown jewels.”

The Tax Court was unpersuaded by the IRS’s argument for many reasons, but it focused on two. First, the court determined that the IRS’s realistic alternatives approach “would make the cost-sharing election, which the regulations explicitly make available to taxpayers, altogether meaningless.” Second, the court, as it noted in

⁴ *Id.* at 118.

⁵ *Id.* at 157.

⁶ *Amazon v. Commissioner*, 148 T.C. No. 108 (2017).

Veritas,⁷ decided that the IRS's realistic alternatives argument conflicted with the requirement of the regulations that the IRS respect the transactions as actually structured by the parties as long as the transaction has economic substance.⁸

On appeal to the Ninth Circuit, the IRS brief argued that the Tax Court's "restructure" critique conflicts with reg. section 1.482-1(f)(2)(ii)(A) and that the principle doesn't restructure a transition; rather, it re-prices the transaction.⁹ The Ninth Circuit affirmed the Tax Court's decision without discussing the realistic alternatives approach.

The IRS's Interpretation

The Tax Court decisions in *Amazon* and *Veritas* provide the most recent judicial declarations regarding the merits of the IRS's realistic alternatives approach.¹⁰

It is important that the scope of the *Amazon* and *Veritas* decisions concerns pre-2009 cost-sharing regulations, which were substantially overhauled through cost-sharing regulations issued in temporary form in 2009¹¹ and finalized in 2011.¹² The current cost-sharing regulations reflect many of the theories and arguments that the IRS advanced in *Veritas* and *Amazon*, and the TCJA amendments to section 482 have essentially codified the RAP as argued by the IRS in *Veritas* and *Amazon*.

Sound Economic Principles

The issue presented asks whether the IRS's interpretation/U.S. transfer pricing regulations are consistent with the OECD guidance on sound economic principles.

According to the OECD, sound economic principles must be compatible with the arm's-length principle and reflect the realities of the controlled taxpayer's particular facts and

circumstances while adopting the normal operation of the market as a benchmark.¹³ In the United States, the RAP is not a replacement for the arm's-length standard and must meet the requirements of the best method approach to achieve a reliable outcome. The RAP must be considered as part of the comparability analysis under reg. section 1.482-1(d), and the comparability is a determinant of the best method under reg. section 1.482-1(c). Therefore, the RAP endorsed by OECD guidelines closely resembles the concept as described in the section 482 regulations, and both are largely interpreted as a valuation concept.¹⁴

Since the 2015 base erosion and profit-shifting final report on actions 8-10 was formally adopted, the OECD has issued 2017 transfer pricing guidelines on control over risk and intangible development, enhancement, maintenance, protection, and exploitation (DEMPE) functions. Although the United States has not directly adopted the OECD guidelines, Treasury has maintained that the OECD guidelines are consistent with general Treasury regulations — that is, that the section 482 regulations already contain similar concepts in line with the principles in BEPS actions 8-10.

But even if the U.S. regulations are conceptually similar, are they consistent in application? Transfer pricing litigation and the divergent approaches to risk between the OECD and U.S. regulations may suggest otherwise.¹⁵

Challenges posed by the COVID-19 pandemic will no doubt contribute to the need to address the section 482 regulations in light of the TCJA, ensure alignment with OECD guidelines, and take into account potential changes brought by any international tax reform. Clarification about the role of economic substance and respect for the

⁷ *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *nonacq.*, No. 12075-06 (2010).

⁸ Referring to reg. section 1.482-1(f)(2)(ii)(A).

⁹ Molly Moses, "Tax Court's Amazon Ruling Thwarts Reg's Purpose, IRS Says," *Law360*, Mar. 30, 2018.

¹⁰ Because Treasury and the IRS issued the section 482 regulations in 1994. PwC, "Tax Court in *Amazon* Rejects IRS's Proposed Application of Income Method for Pricing Cost-Sharing Buy-In Payments," at 4 (May 2, 2017).

¹¹ T.D. 9441.

¹² T.D. 9568.

¹³ OECD, "Revision of the Recommendation of the Council on the Determination of Transfer Pricing Between Associated Enterprises," at 1.14 (June 29, 2010).

¹⁴ For a deeper discussion, see Ryan Finley, "The U.S. Transfer Pricing Regulations' Risky Approach to Risk," *Tax Notes Int'l*, May 10, 2021, p. 723.

¹⁵ See Finley, "Disputes Over Recharacterization Spread in Transfer Pricing," *Tax Notes Int'l*, Nov. 16, 2020, p. 980. See also Finley, *supra* note 14; but see Finley, "After *Coca-Cola*, Practitioners See DEMPE as Part of U.S. Law," *Tax Notes Int'l*, May 24, 2021, p. 1133 ("The *Coca-Cola* opinion suggests that the Tax Court may now interpret U.S. law in a way that incorporates OECD guidance on control over risk and intangible DEMPE functions.").

taxpayer's actual transaction after the TCJA will help address any abuse of discretion exercised by the IRS and indicate whether the U.S. regulations truly align with OECD guidelines.

Useful Life and Decay Rates — Hannah Karraker and Franklin Shen

Consider the Tax Court's discussion in *Amazon* of the useful life and decay rates of the transferred intangibles. Do the Court's conclusions make sense in light of its finding of fact or economic principles?

We considered the Tax Court's discussion in *Amazon* of the useful life and decay rates of transferred intangibles from Amazon U.S. to its European subsidiary.

Perpetual vs. Limited Useful Life

Amazon's argument relied on the regulations, stating that the buy-in payment should represent compensation solely for the use of preexisting intangibles, and that new products or services would add to the existing IP, reflected in the cost-sharing agreement. While the commissioner attempted to argue that the existing technology could be valued in perpetuity, equating the transfer of preexisting intangibles to the sale of the entire business, the court agreed with Amazon that compensation for subsequently developed IP shouldn't be covered in the buy-in, but rather would be dealt with in the cost-sharing agreement.

Royalty Rate

The royalty rate analysis for the intangibles was split into two parts: first, the determination of a base rate; and second, whether a volume adjustment should be applied. The commissioner chose a base rate of 4 percent from a single comparable agreement that Amazon had with Target, contending that it was the single most comparable agreement to the underlying transaction. On the other hand, Amazon analyzed deal decks to back out a range of rates from 1.4 to 4.4 percent, which the court was more inclined to agree with. The court agreed that a middling rate of 3.3 percent was appropriate because Amazon's process was more proper.

Application of the volume adjustment was based on the observation that the industry accepts the notion that there is a negative correlation between sales volume and royalty rates across transactions. However, of the four largest comparable agreements, only two had adjustments, both of which were by 50 basis points. The court ended up splitting the baby by using a 25-basis-point adjustment. While the court's decision is understandable, it brings into question just how persuasive industry standards really are. It seems that industry practice established the appropriateness of the adjustment here, but the court applied its own discretion to determine the extent of the adjustment.

The court also applied a royalty rate for the separate marketing intangibles, finding the structural norm in other multiple agreements to be more persuasive and applying a flat rate of 1 percent. It remains unclear why the court was less willing to engage in a more detailed analysis of the underlying marketing intangibles while it spent numerous pages discussing the merits and aspects of the underlying technology.

Decay Rates

Amazon contended a "ramp down" decay curve was necessary to correlate the buy-in to the value of the preexisting intangibles, originally developed in 2005, which gradually declined in value as major components were modified or replaced. Without such a decay rate, the cost-sharing regulations would be violated, and as the court found in *Veritas*, "an adjustment must be made to the stated royalty rate to account for the static nature of original technology."¹⁶ Without ramping down, Amazon's European subsidiary would be required to pay for subsequently developed intangibles twice — in the cost-sharing agreement and inflated buy-in price. The court agreed, finding the commissioner's method failed to eliminate from the buy-in payment the value of subsequently developed intangibles by ignoring the relative contribution of both parties.

¹⁶*Veritas*, 133 T.C. 297.

Discount Rate

Amazon used the Capital Asset Pricing Model (CAPM) and a beta of 2 and monthly data to calculate the weighted average cost of capital (WACC) to be 18 percent. Notably, this is the same WACC that the commissioner used under the discounted cash flow model that the court threw out early in its opinion. However, using CAPM, a beta of 1.55, and weekly data, the commissioner came up with a WACC of 14 percent. Another of the commissioner's experts used a beta of 1.45 calculated not from Amazon's own data but from that of comparable companies. The court, agreeing with Amazon's entire method, found that monthly data more accurately measured volatility compared with the market and that when data on the underlying taxpayer is available, it should be used instead of consulting data from other companies.

Conclusion

Overall, we agree with the court's decision regarding the IP because it incorporated understood industry practices and sound principles of economics and valuation. We are less sure if the assumptions the court made regarding the underlying IP also applied to the marketing intangibles. A deeper analysis of how Amazon marketed its web technology would have allowed for greater precision in determining the applicable useful life and royalty rate.

2021-2022 TP C2B Launch

Planning is underway for the second year of TP C2B. The committee believes — and our pilot-year mentors and mentees heartily agree — that the program is valuable. It serves the legal educational and diversity objectives of the ABA, the tax section, and the transfer pricing committee. It builds connections between people and invests in the future of our profession. Our mentors are already leaders in this field; our mentees are the next generation. With the continued sponsorship of the ABA tax section and growing engagement from the corporate sector, the committee hopes to transform TP C2B from a start-up project into an institution, with larger cohorts of mentors and mentees each year.

Watch this space. ■

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