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77th Annual Conference
Scottsdale, AZ

International Tax Controversy
–
APAs, Competent Authority, and MAP proceedings

October 24, 2022

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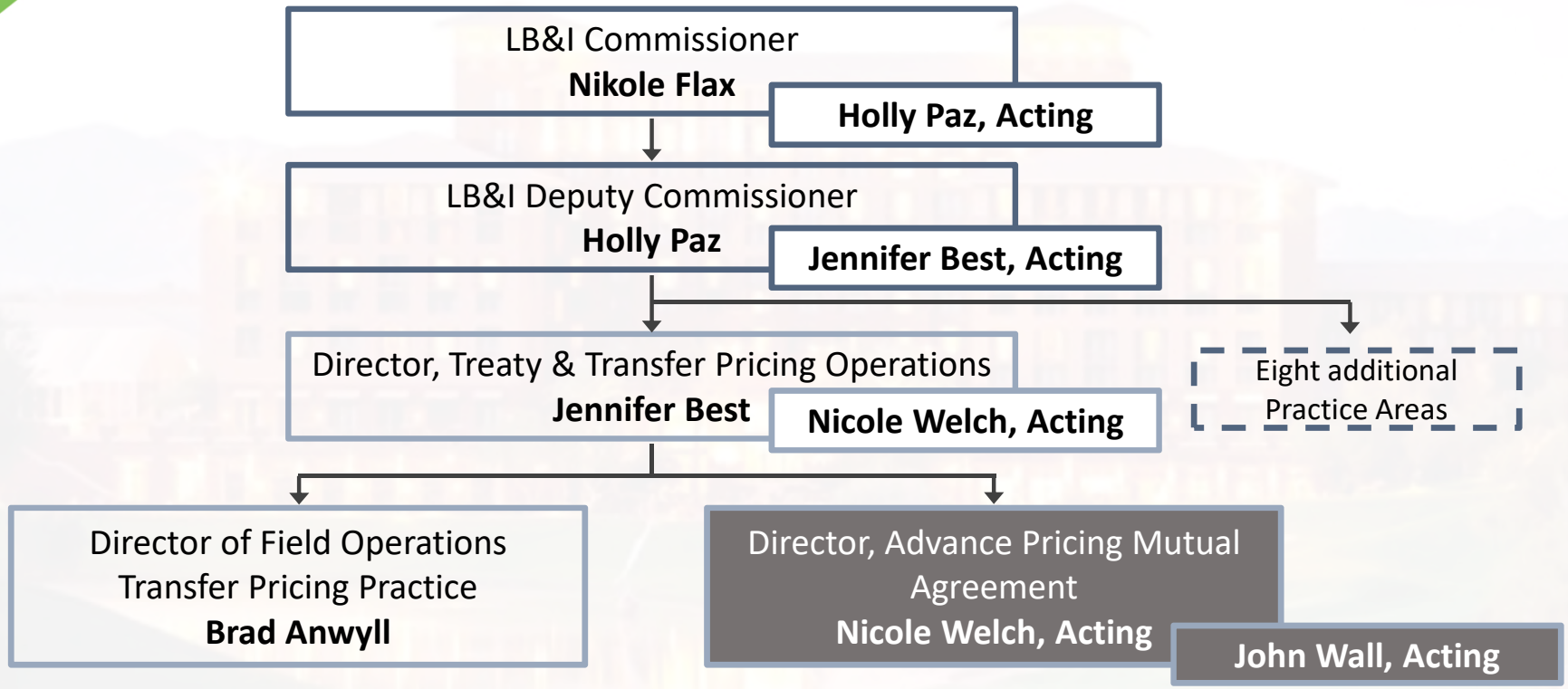
Fulbright

Brian Kittle/Partner
/Mayer Brown LLP

IRS Transfer Pricing Organization



IRS Transfer Pricing Organization

Director, Advance Pricing Mutual Agreement
Nicole Welch, Acting

John Wall, Acting

Group A	Group B	Group C	TAIT
Assistant Director **John Wall** Washington, DC	**Assistant Director** **Judith Cohen** Washington, DC	**Assistant Director** **Dennis Bracken** Los Angeles, CA	**Assistant Director** **Melanie Godelis (A)** Washington, DC
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Revisions to APMA/MAP Procedures

- APMA is revising Rev. Proc. 2015-40 (procedures for MAP requests) and 2015-41 (procedures for APA requests)
- Requested comments
- Expectations:
  - Streamline/simplify application and process
    - Reduce burdens
    - Limit information requirements to essential information
  - Internal process changes
    - APMA to be more selective re APA it accepts**, not guaranteed**
    - Resource constraints: risk assessment in Exam also applies in APMA
    - Considering joint audits

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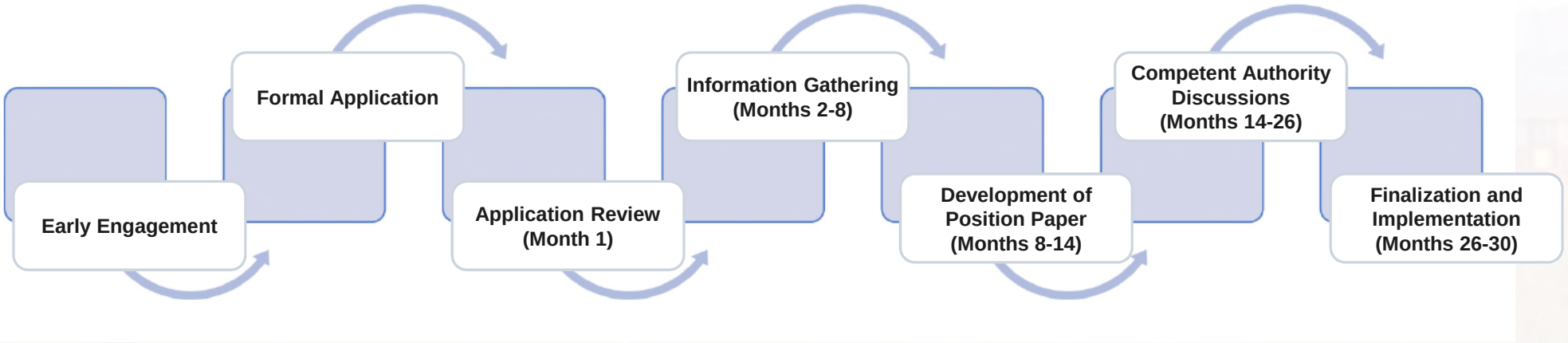
Advanced Pricing Agreements

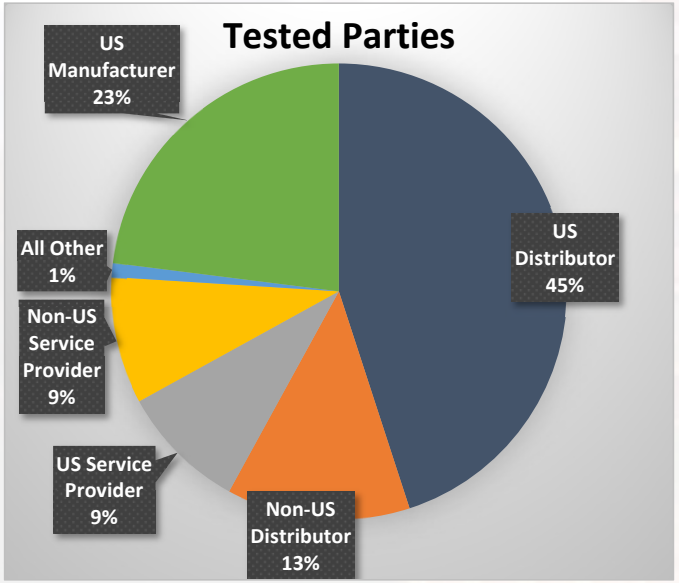
OECD Model Bilateral APA Process

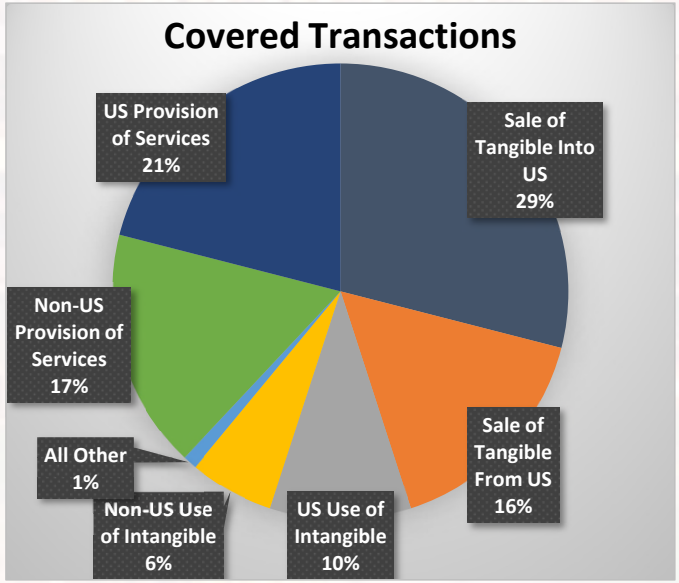


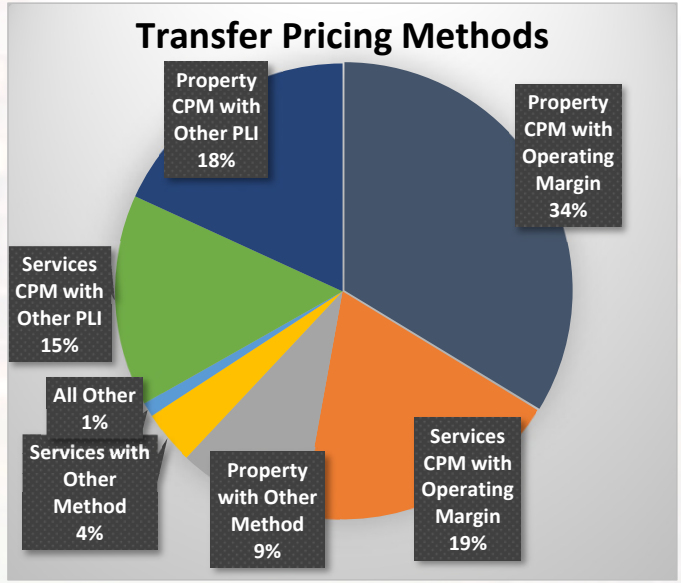
Source: Bilateral Advance Pricing Arrangement Manual @ OECD 2022

APA Statistics

- Tested Party: 58% Distributors
- Covered Transactions: 45% Sales of tangible property
- Method: 53% CPM/TNMM with Operating Margin







Source: APMA Annual Report 2021

OECD Bilateral Advance Pricing Arrangement Manual

- OECD APA Manual focuses on best practices
- Communicate, communicate, communicate
  - Principled, fair, objective, transparent communication
  - Notify both Competent Authorities ahead of time / provide information to both parties at the same time, transparent
  - Share disagreements as soon as possible / keep other competent authority informed
  - Competent authorities not try to influence position
  - Competent authorities do not share position papers with taxpayers
  - Work on alternatives, willingness to change

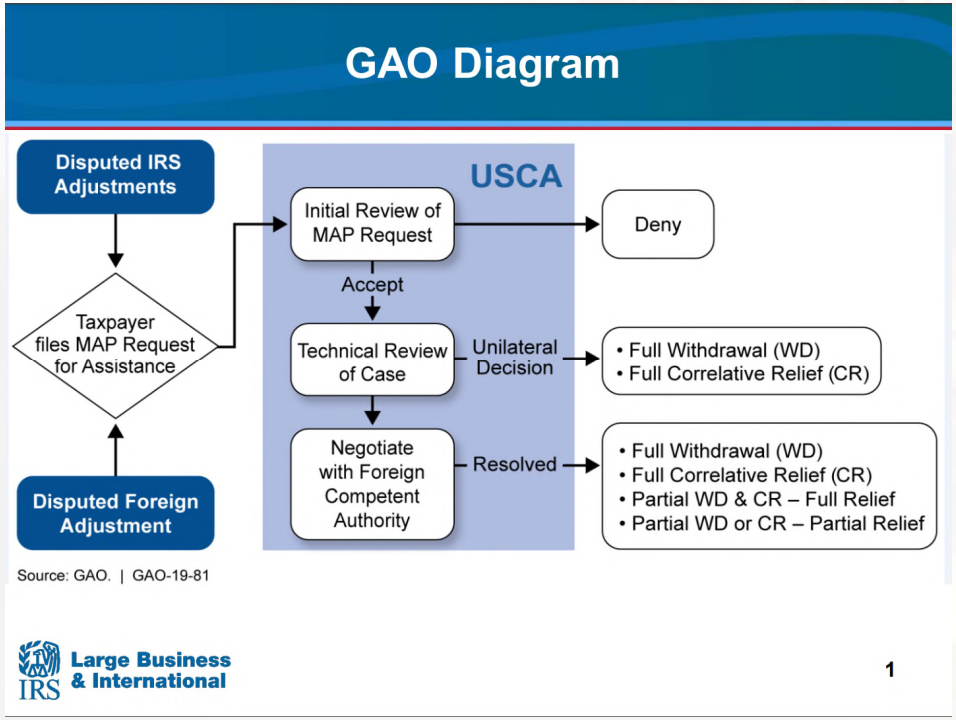
Mutual Agreement Procedure

- Treaty-based dispute resolution mechanism designed to eliminate double taxation
  - Available for both foreign initiated adjustments and U.S. initiated adjustments
  - May be necessary to qualify for foreign tax credits
- BUT
  - Only available for countries with tax treaties
  - Taxpayer excluded from negotiations
  - Often takes years to complete
  - May not resolve the issue
  - Not all treaties contain arbitration provision

- Covered issues
  - Transfer pricing
  - Royalties, interest, withholding taxes
- Permanent establishments
  - Other issues that give rise to double taxation
  - Certain interpretation issues

- Procedures set forth in Rev. Proc. 2015-40 (*being revised*)
  - Taxpayers are encouraged to file request after a competent authority issue arises or is likely to arise
- Consider pre-filing conference
  - Mandatory for taxpayer-initiated adjustments
  - Recommended for issues that are complex, large in amount, novel, or likely to involve interrelated issues
- Consider Treaty Notification.
  - Treaty Notification may be appropriate where (a) treaty country is considering but has not yet proposed an adjustment; (b) the treaty country has proposed an adjustment but the related party in the treaty country decides to pursue administrative or judicial remedies in the foreign country; or (c) the terms of the applicable treaty require notification to be made to the competent authority within a certain time period.
  - Provide annual notification until a complete competent authority request has been filed

Mutual Agreement Process



- The IRS encourages taxpayers to use the Mutual Agreement Process
  - Rev. Proc. 2015-40: opportunity for negotiation for correlative relief could be lost if resolution moves forward at Appeals
  - CAP requires submission of Material Intercompany Transactions Template which may result in referral of transfer pricing issues to APMA
  - Series of LB&I Directives on transfer pricing (beginning in January 2018) require centralized review prior to issuing the formerly mandatory transfer pricing IDR and proposing a change in transfer pricing method

Watch Out For Time Limitations In Treaties

- Beware of treaty provisions that may provide time limitations for requesting Competent Authority Assistance.
  - Article 2[illegible] endeavor . . . to reso[illegible]cting State . . . provid[illegible] within four and a half years from the due date or the date of filing the return in that other state, whichever is later." (emphas[illegible])
  - Article 24 [illegible]within three years from the first notification of that action." (emphasis added)
- Some of our Treaty Partners take a restrictive view on these time limitations

notified of the case within four and a half years from the due date or the date of filing the return in that other state, whichever is later."

presented within three years from the first notification of that action." (emphasis added)

Certain Issues That May Arise During MAP

- Interplay between foreign procedures and MAP
  - Local bonding or other requirements
  - Foreign procedures don't allow companies to pursue domestic remedies and MAP simultaneously
  - Dispute is designated for litigation
- Foreign government refuses to participate in MAP
  - Foreign government claims its purely domestic issue
  - Personnel at foreign government keep changing
- Dispute becomes financially immaterial
- Settlement offered by foreign tax authority before MAP process concluded?

Must You Accept A Proposed MAP Resolution: FTC Eligibility

- Field Service Advice 1998-293
  - "[T]here is authority that taxpayer may not claim a credit for the tax that Japan is willing to concede in a competent authority settlement but which taxpayer is unwilling to accept."
  - "It is possible that the Government would have an argument that [redacted text] in refusing to accept a competent authority settlement . . . has made a voluntary payment to Japan in the amount of tax that the Japanese competent authority is willing to concede."
- Field Attorney Advice 20125202F
  - "Although the proposed CA settlement was based on a smaller amount of constructive dividend than it ultimately obtained through its litigation and settlement with the Foreign Tax Agency, the exhaustion of remedies requirement is based on reasonable expectations at the time the avenue of relief is foregone, not hindsight."

Protective Claims For Refund In MAP

- Protective claim for refund may be made by either: (a) including the claim in Competent Authority Request, or (b) filing a letter making a protective claim under Rev. Proc. 2015-40 in relation to an issue on which competent authority assistance may be requested. See Rev. Proc. 2015-40, Sections 11, 2.02, Tab 3 of Appendix.
- A protective claim must: (a) fully advise the IRS of the grounds on which credit or refund is claimed; (b) contain sufficient facts to apprise the IRS of the exact basis of the claim; (c) describe and identify the contingencies affecting the claim; (d) state the year for which the claim is being made; (e) be verified by a written declaration under penalties of perjury, and (f) be filed before the expiration of the period of limitations. Rev. Proc. 2015-40, Section 11.

Protective Claims For Refund Outside Of MAP

- Field Attorney Advice 20125202F
  - "[A] valid protective claim need not state a particular dollar amount or demand an immediate refund, but it must be sufficient to put the Service on notice that a tax refund is sought, focus the Service's attention on the merits of the claim, and identify the specific years for which a refund is sought."
- Sample Language
  - The amount of the refund requested by the company is contingent upon the resolution of the foreign tax assessments. After the dispute with the foreign tax authority regarding the foreign tax assessments is ultimately resolved, the company will file an additional refund claim that amends this protective claim to account for any additional foreign tax credit for which the company is entitled for the 20XX tax year.

Settlements Outside Of MAP

- Documentation matters
  - Make sure your documentation is in order
- Settlements of more than one issue are evaluated on an overall basis
- What are other companies doing?
- Amnesty programs
  - Private Letter Rulings 8323094 and 8339036

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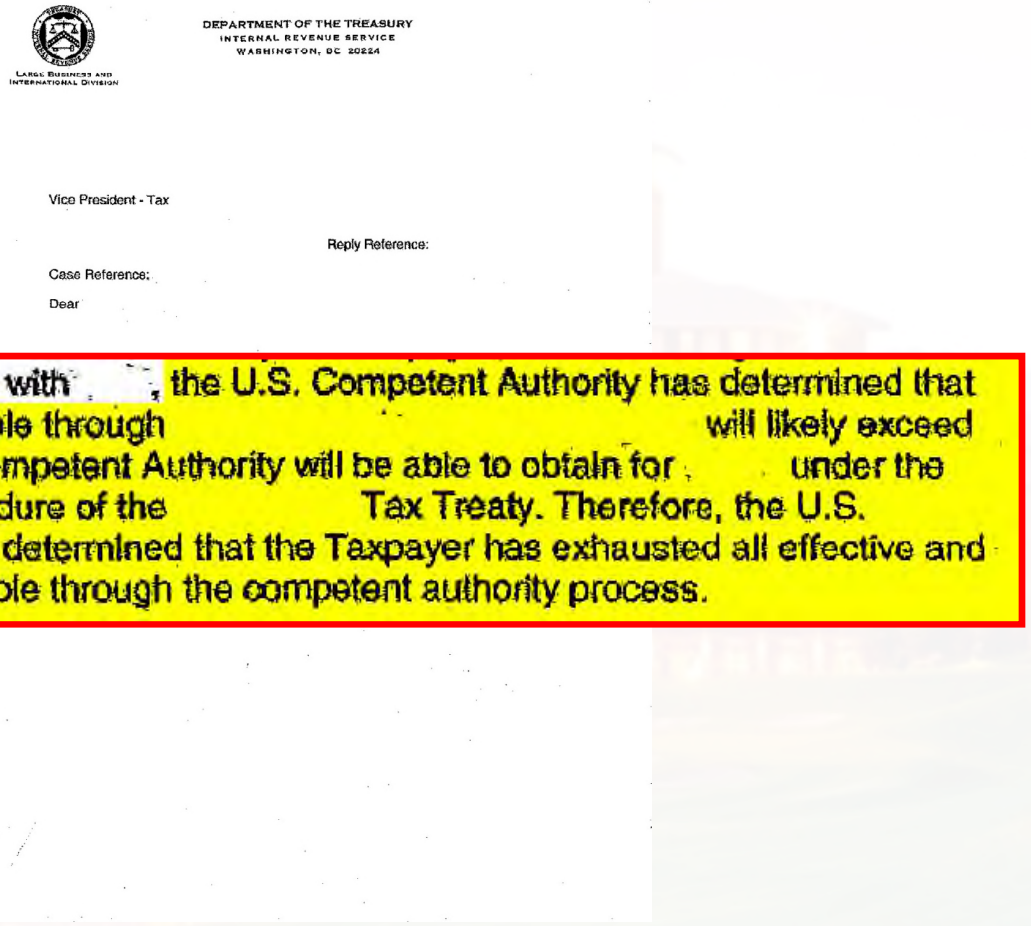


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

LARGE BUSINESS AND INTERNATIONAL DIVISION

Vice President - Tax

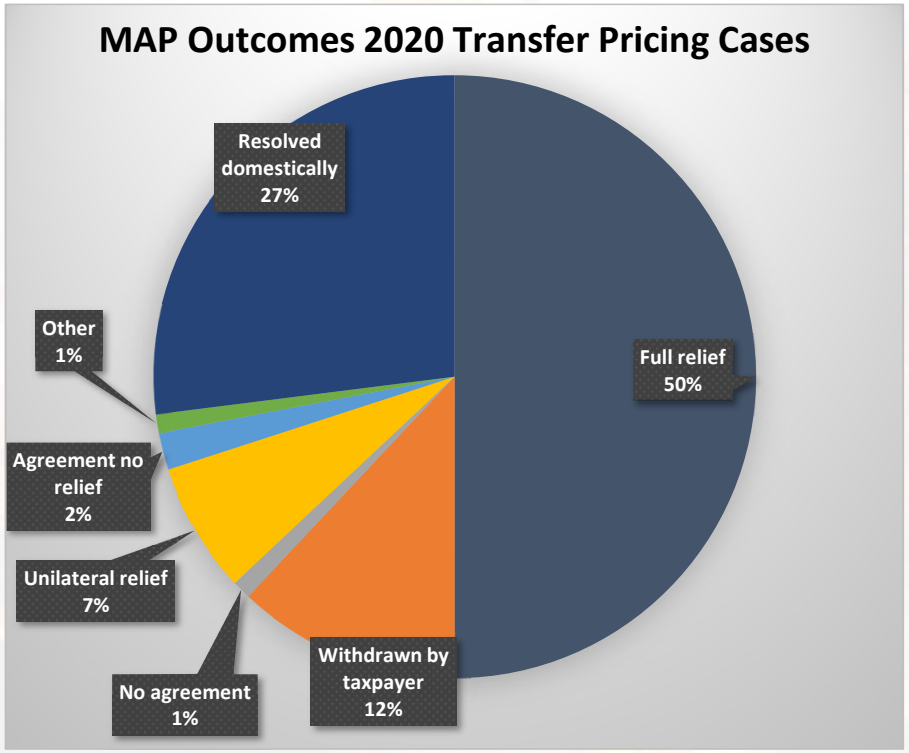
Reply Reference:

Case Reference:

Dear

status of the negotiations with , the U.S. Competent Authority has determined that the relief currently available through will likely exceed the relief that the U.S. Competent Authority will be able to obtain for under the Mutual Agreement Procedure of the Tax Treaty. Therefore, the U.S. Competent Authority has determined that the Taxpayer has exhausted all effective and practical remedies available through the competent authority process.

MAP Statistics



- US Mutual Agreement Program results in successful resolution in over 80% of cases

Source: https://www.oecd.org/tax/dispute/2020-map-statistics-united-states.pdf

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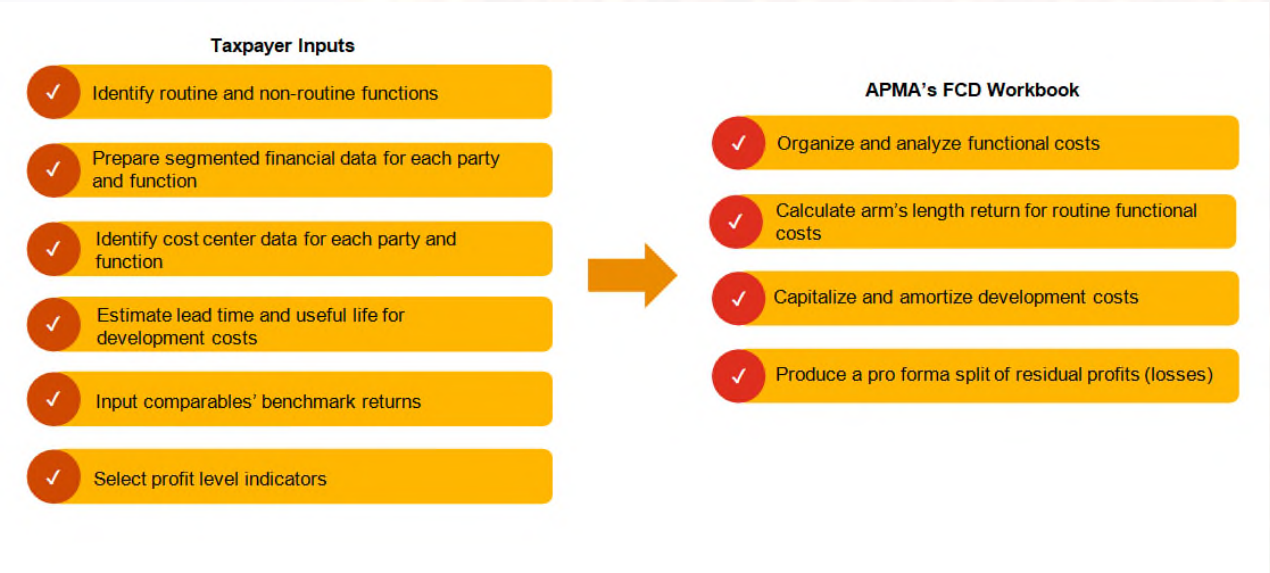
Emerging Issues In International Tax Disputes

Emerging Issues:

- Cases
- Sec. 367
- Aggregation
- Income Blocking Statutes
- Tax Credit

- Common issues in recent US tax cases involving transfer pricing
  - Agreements with the IRS: Will the IRS **respect** those agreements or the parties' course of conduct?
    - *Eaton*, *Coke*, *Medtronic*
- *Medtronic* –
  - Could the Tax Court's adoption of an unspecified method effectively result in the use of profit splits going forward?
  - What does the Court's opinion signal about understanding the system profit of a particular business or product?
  - Does the Court's opinion indicate that taxpayers ought to be testing both sides of any transaction?

Key Emerging Topics: APMA Functional Cost Diagnostic Workbook



- Excel model developed in 2019 to assist in gathering information and analyzing case, continuous update
- Expect request in significant cases
- Structured as residual profit split (taxpayer to add costs)
  - Taxpayers must distinguish between routine and non-routine costs
  - APMA states not moving to more use of profit split

- Sec. 367 Arguments
  - The IRS lost its sec. 367 arguments in both *Eaton* and *Medtronic*. It didn't appeal those holdings in either case.
  - Do taxpayers still need to be concerned about these arguments?
- Aggregation
  - Are taxing authorities starting to apply aggregation principles more frequently?
  - What can taxpayers do to be prepared for these types of arguments?

- Income blocking statutes: taken into account or not taken into account?
  - *3M, Coke*
- Tax Credits
  - Was the foreign payment compulsory?
  - What is the role of the relation-back rule?
  - When do taxpayers accrue a foreign tax if it's being disputed?

- Foreign payment must be “compulsory” to qualify for foreign tax credit.
  - A foreign payment must be determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign tax law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign tax law for foreign income tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign income tax (including liability pursuant to a foreign tax audit adjustment).
  - A taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts.

- Relation-Back Rule" applies
  - Additional tax paid as a result of a change in foreign tax liability (including resolving a foreign tax dispute) relates back to the foreign tax year with respect to which the tax is imposed
  - Reminder. The creditability of foreign taxes (such as withholding taxes) for tax years that relate back to tax years beginning **before** December 28, 2021, should be governed by the older rules (e.g. no attribution test)
- Contested foreign income taxes
  - Do not accrue until the contest is resolved even if paid in an earlier year before the resolution
  - Example. If foreign tax dispute for the 2023 tax year is resolved in 2025, then the foreign tax credit relates back to 2023 and affects the 2023 foreign tax credit and other items
- Provisional credit relief
  - May claim provisional credit (not deduction) for contested foreign taxes paid if taxpayer agrees to certain conditions (reporting requirements and statute of limitation)

Tax Credits: Compulsory Payments - Credit v. Deduction

- Choice between credit and deduction made on original or amended return for the tax year
- Election made on year-by-year basis
- Exception for taxes that relate back to earlier tax year
- Final Regulations contain time limitations during which taxpayer may choose or change its election to claim a credit or deduction for foreign taxes (these rules are tied to the applicable statute of limitation periods)
- Claim credit (or change from deduction to credit) within the 10-year statute of limitations
- Claim deduction (or change from credit to deduction) within the 3-year statute of limitations
- Change in election between credit and deduction is treated as a foreign tax redetermination (allows IRS to assess and collect tax deficiencies resulting from the change in election)

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Key Emerging Topic:

Implied Support & Passive Association

(*They are not one in the same, despite what you might hear*)

- On August 17, 2022, the Treasury Department and the Internal Revenue Service ("**IRS**") issued an update to their Priority Guidance Plan for 2021-2022 (the "**Plan**").
- It includes Regulations under §482 clarifying the effects of group membership (e.g., ***passive association***) in determining arm's length pricing.
- This description is unchanged from when Treasury issued its Plan on September 9, 2021.

- When pricing intercompany debt, the traditional approach was to respect the subsidiary / debt issuer's corporate separateness.
  - *NOTE*: Taxing authorities assume that passive association and implicit support are one in the same. They are not. Passive association, as its name states, concerns benefits that don't require any activity by any party. Implicit support assumes that the recipient can call upon the support provider who will provide that support.
- But the OECD has taken the position that (1) implicit support, that is, assumed financial support from the group to the issuer, must be taken into account in determining the arm's length rate, and (2) implicit support is an "**incidental benefit**" the issuer receives "*solely by virtue of group affiliation*."
  - The effect of the implicit support on issuing entity's "ability to borrow or the interest rate paid on those borrowings would not require any payment or comparability adjustment." OECD, Transfer Pricing Guidance on Financial Transactions.

- Three questions arise:
  - Does implicit support have to be taken into account when pricing intercompany debt or when pricing an express guarantee fee on debt a subsidiary issues?
  - If so, does it provide a large or small benefit to the debt issuer?
  - Is implicit support a compensable transaction, that is, if a taxing authority is imposing a fictional contract, should the guarantor be paid for lending its balance sheet to the debt issuer?

Passive Association – Current Law

- Why should taxpayers focus on Implicit Support and Passive Association?
  - The IRS's 2021-22 priority guidance plan includes issuing Regulations under §482 "**clarifying** the effects of group membership (e.g., passive association) in determining arm's length pricing, including specifically with respect to financial transactions."
- Where is Implicit Support and Passive Association found in the current Transfer Pricing Regulations?
  - Passive Association is located in the Services Regulations (Treas. Reg. 1.482-9(l)).
  - Implicit Support is not found in the transfer pricing regulations.
- Where is Passive Association not found in the current Transfer Pricing Regulations?
  - It is not referenced in Treas. Reg. 1.482-1, which provides general legal and economic framework applicable to, *inter alia*, the comparability analysis.
  - It is not referenced in Treas. Reg. 1.482-2, which addresses specific types of transactions, including intercompany debt.
  - It is not referenced in Treas. Reg. 1.482-4, which addresses the pricing of intercompany intangible transactions.
  - There is no reference in Treas. Reg 1.482-9 that passive association was to apply outside of service transactions.

- What is a compensable Services Transaction under Treas. Reg. 1.482-9?
  - A Compensable Services Transaction has two economic characteristics.
  - A "controlled services transaction" occurs were one member of a controlled group undertakes "**an activity**" that "**results in a benefit**" to one or more members of the group.
- Note that financial transactions, like guarantees, are not services.

- Focusing only on passive association, what constitutes passive association?
  - The regulations suggest there are two aspects of passive association (Treas. Reg. 1.482-9(l)(v)):
    - A controlled taxpayer will "generally" not be considered to have received a benefit where that benefit "results from the controlled taxpayer's status as a member of a controlled group."
    - A "controlled taxpayers' status as a member of a controlled group may … be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions."
- When does a benefit "result from the controlled member's status as a member of a controlled group?"
  - The preamble to the 2003 Proposed Regulations provides an answer to this question:
    - "Proposed § 1.482–9(l)(3)(v) provides that a member of a controlled group that obtains a benefit ***solely on account of*** its status as a member of the group (for example, by obtaining favorable commercial terms from an uncontrolled party by reason of its membership in the controlled group) is generally not considered to receive a benefit." 68 Fed. Reg. 53457 (emphasis added).

Passive Association – OECD Guidelines

- The OECD's guidance regarding "***group synergies***" distinguishes:
  - "***incidental benefits*** attributable solely to [an enterprise] being part of a larger MNE group [i.e., passive association]," which are non-compensable (OECD Guidelines, ¶1.158)
  - benefits that "arise because of ***deliberate concerted group actions*** and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace," which are compensable (¶1.159)
- Example 2 (¶1.167) – loan guarantee from Parent (P) to Subsidiary (S)
  - P's credit rating = AAA
  - S's standalone credit rating = Baa
  - Analysis indicates that S could borrow from 3rd party bank at "A" rate without a guarantee
  - P's explicit guarantee allows S to borrow at P's AAA rating
  - Example concludes
    - Credit enhancement from Baa to A is non-compensable ***passive association***
    - Credit enhancement from A to AAA is attributable to ***deliberate concerted action*** and compensable

- Example 3 (¶1.168) – Centralized Procurement
  - Company A is central purchasing manager for MNE
  - Based solely on the negotiating leverage provided by the purchasing power of the entire group, A negotiates to reduce the price of widgets from $200 to $110.
  - Example concludes the arm's length price for sales of widgets to other group members is $110 plus a services fee to A ($6 in the example). Charging $200 was non-arm's length. Group purchasing power benefit of $84 per widget retained by each group member.
  - But what if A leveraged special relationships with vendors or otherwise obtained the benefit through ***deliberate concerted action*** that no individual group member could obtain on its own?
- As examples indicate, synergy guidance probably has its most direct application to financing and purchasing transactions, but has potential to raise broader, fundamental questions about the arm's length standard.

International CAP

International Compliance Assurance Programme (ICAP)

- Simultaneous review of transfer pricing risks by several jurisdictions cooperatively
- Expanded to 22 countries (from initial 8)
- "Risk assessment process" – establish risk profile
  - Review transfer pricing documentation, country-by-country reports
  - Kickoff meeting, share information with all countries
  - Participating countries each assess risks
  - Each country prepares "CAP outcome letter"
  - Assessment of "high risk" results in examination
- Advantages / disadvantages
  - Different assurance – non-binding risk assessment
  - Much faster (24-28 weeks)
  - Cover more countries
  - Good for medium risk taxpayer without aggressive structures

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Recent Transfer Pricing Cases

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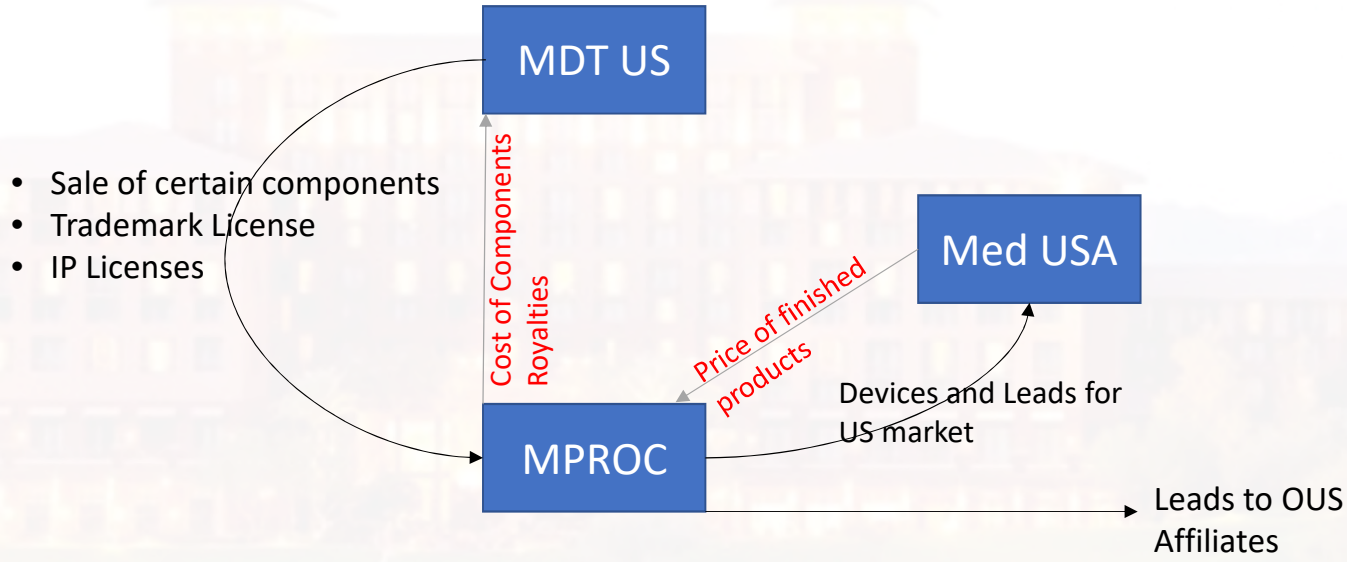
Medtronic v. Commissioner

- Two Issues
  - Section 482: What's the arm's length royalty rate for Medtronic Puerto Rico to pay Medtronic U.S. to license IP for the manufacture and sale of medical devices?
  - Section 367(d) Alternative: If the royalty is correct, did Medtronic U.S. transfer compensable IP to Medtronic Puerto Rico subject to section 367(d)?

Medtronic: Intercompany Transactions



Tax Court in *Medtronic I* held that the taxpayer's:

- Price of components was arm's length
- Sale of finished products was arm's length
- Trademark license was arm's length

U.S. Transfer Pricing Litigation – *Medtronic*

Medtronic I (T.C. Memo. 2016-112)

- Rejected IRS's CPM
  - CUT method was the best method
  - Pacesetter Agreement, with adjustments, was a good comparable
- Rejected §367 argument: failed to identify transfer property

Medtronic II (900 F.3d 610 (8th Cir. 2018))

- Vacated Tax Court decision and remanded for additional factual development on whether the Pacesetter Agreement was an appropriate CUT
- US did not raise §367 on appeal

Medtronic III (T.C. Memo. 2022-84)

- Rejected IRS's CPM
- Rejected the Pacesetter Agreement as a CUT
- Adopted a multi-step unspecified method that incorporates aspects of the CPM and the CUT to split profits between U.S. and Puerto Rican affiliates

Medtronic III: Rejection of Pacesetter CUT

- Tax Court held Pacesetter Agreement is not a CUT under Treas. Reg. §1.482-1(d)
  - MPROC and Pacesetter did not perform same functions
  - Profit potential of Pacesetter Agreement and IP Licenses not the same
  - IP licensed in Pacesetter Agreement and IP Licenses not the same

    "Three of the five general comparability factors are not met … Since we conclude that the general comparability factors are not met, we do not need to analyze the circumstantial comparability factors to determine whether the Pacesetter agreement is a CUT." Op. at 32

Medtronic III: Court's Unspecified Method Detail by Transaction

- Return on IP Licenses
  - Applied the high end of taxpayer's adjusted Pacesetter CUT royalty range (17.3%)
  - Concludes there are issues with the taxpayer's CUT ("not perfect"), but the final profit split addresses these issues
- Return on Trademark License
  - Accepted taxpayer's CUT method in *Medtronic I* as arm's length
  - Not at issue in *Medtronic III*

Medtronic III: Court's Unspecified Method Detail by Transaction

- Return for Finished Device Manufacturing
  - Accepted taxpayer's MPROC "asset intensity" adjustment to IRS modified CPM (only 5 "comparable" companies)
  - Increased MPROC's ROA to make it more comparable to 5 companies
- Court concluded:
  - No support for taxpayer's asset intensity adjustment from 13.3% to 52.3%, but didn't know how to adjust this
  - IRS's 5 comparable companies aren't comparable

Medtronic III: Unspecified Method Detail by Transaction

- Return on Distribution
  - Accepted taxpayer's CPM method in *Medtronic I* as arm's length
  - Not at issue in *Medtronic III*
- Return on Components Manufacturing
  - Accepted taxpayer's CPM method in *Medtronic I* as arm's length
  - Not at issue in *Medtronic III*
- 80/20 Residual Profit Split
  - No method, no basis
  - Appears to be results driven

Medtronic: Methods and Results

Start ↓ End ↓

	Putnam CUT (low)	Berneman CUT	MDT Petition/ 6662 Doc	Putnam CUT (high)	MDT Unspecified (35-65)	Tax Court (Medtronic I)	MOU	MDT Unspecified (50-50)	Tax Court (Medtronic III)	Modified CPM	Pacesetter CPSM	Heimert CPM
Blended Royalty	**21.8%**	**25.0%**	**25.2%**	**33.1%**	**35.7%**	**38.0%**	**39.1%**	**40.0%**	**48.8%**	**62.2%**	**62.4%**	**66.7%**
Profit Split (US/PR)	**32.2/ 67.8**	**36.5/ 63.5**	**36.8/ 63.2**	**47.5/ 52.5**	**51.0/ 49.0**	**54.1/ 45.9**	**55.6/ 44.4**	**56.8/ 43.2**	**68.7/ 31.3**	**86.9/ 13.1**	**87.1/ 12.9**	**93.0/ 7.0**

- Royalty rate is the "blended" rate for Devices and Leads
- Medtronic conceded that Devices and Leads should have the same royalty rate in MDT III

- Medtronic
- IRS
- Tax Court

Eaton Corp. v. Commissioner

- Eaton and the IRS executed advance pricing agreements ("APAs") covering 2001-2005 and 2006-2010.
- Covered manufacturing of breaker and electrical control products in Puerto Rico and the Dominican Republic.
- Modified CUP method that guaranteed U.S. distributor a certain return on expenses (Berry ratio).
- First APA also included a technology royalty using a CUT.

- The IRS selected Eaton's 2005-2006 tax years for examination and asserted deficiencies of more than $75 million, plus penalties.
  - The IRS cancelled the APAs, claiming that Eaton misrepresented or omitted material facts in negotiating the APAs and failed to comply with the terms and conditions of the APAs.
  - The IRS applied a CPM, which provided Eaton's foreign manufacturing entities with a return on capital employed for what it viewed as routine contract manufacturing.
- A five-week trial was held in 2015 on both the APA cancellation and substantive transfer pricing issues.

Eaton: Tax Court Opinion

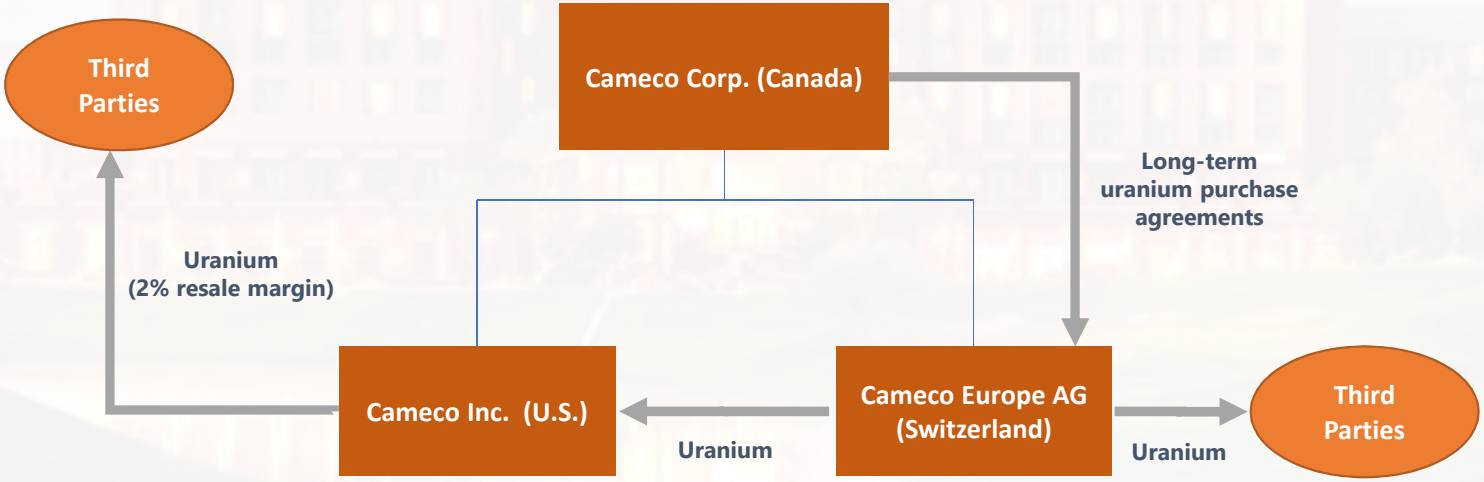
- The Tax Court held that the IRS abused its discretion by canceling the APAs.
- Eaton advocated for the CUP method in combination with the CPM throughout the APA negotiations, and the IRS had multiple opportunities to reject Eaton's method or to suggest a different method; it never did so.
- Eaton's errors in connection with the APAs were immaterial and inadvertent and not sufficient grounds for the IRS to cancel the APAs and switch to a transfer pricing method it never raised during the negotiations.

- As an alternative to the cancellation of the APAs and its § 482 argument, the IRS argued that if the court found for Eaton on pricing, then, "as a logical corollary," intangibles were transferred to PR operations in a 2006 restructuring and that transfer was taxable under § 367(d).
  - "The gist of [IRS's] argument is that [the PR operations] could not possibly be as profitable as they are unless intangibles were transferred to them."
- The Tax Court disagreed, holding "[o]n the record before us we do not conclude that intangibles were transferred."
  - The IRS failed to identify any specific intangibles that were transferred
  - Eaton pointed out that, after 2006, PR operations licensed – not owned – intangibles
  - Note that this was based on the pre-TCJA definition of compensable intangibles

- The government appealed, and on August 25, 2022, the Sixth Circuit ruled in favor of Eaton on **all** issues, 47 F.4th 434 (6th Cir. 2022).
- The Sixth Circuit held:
  - The IRS is not entitled to cancel APAs under terms of APAs and underlying Revenue Procedures ("[The IRS] was never entitled to cancel its bargain.")
  - The IRS's cancellation of APAs is subject to review under contract law principles, not a deferential abuse of discretion standard the Tax Court had applied
  - The IRS forfeited its right to § 6662 penalties on taxpayer self-adjustment by rejecting that self-adjustment, thereby failing to raise penalty before or at trial
  - Eaton is entitled to relief from double taxation under Rev. Proc. 99-32

Canada v. Cameco Corp

- Cameco is a Canadian corporation and one of the largest uranium producers in the world.
- The Cameco Group restructured in 1999:



Cameco: Background

- Facts
  - Long-term purchase agreements between Cameco and Swiss Sub were determined based on the market price of uranium in 1999.
  - After amending the agreements in 2001, the Swiss Sub became obligated to purchase uranium from Cameco at the 1999 price.
  - In 2002, the market price of uranium increased significantly.
  - Swiss Sub received a windfall because it was locked into a favorable rate to purchase uranium from Cameco, but could sell the uranium to third parties at market value.
- Adjustment
  - The Canada Revenue Agency ("CRA") reallocated nearly C $500 million of profits to Cameco.
  - CRA asserted that the profits should be reallocated to Cameco on the theory that Cameco, instead of the Swiss Sub, would have bought and sold the uranium itself, if they were arm's length parties.
  - 2003, 2005, and 2006 were the years at issue.
    - Cameco estimated that more than C $2 billion was at stake after accounting for later years.

- The dispute centered on Section 247 of the Canadian Income Tax Act, specifically paragraphs 247(2)(b) and (d).
- Section 247 allows transfer pricing adjustments for transactions that no arm's length parties would enter into, other than for a tax benefit.
- CRA invoked concepts similar to the "realistic alternatives" principle in U.S. tax law.
  - CRA contended that, under a subjective test, all of the Swiss Sub's profits should be allocated to Cameco because Cameco would not have entered into these long-term purchase agreements with an unrelated third party, and would have instead kept the business opportunity for itself to maximize its own profits.

Cameco: Canadian Court of Appeal

- The Canadian Federal Court of Appeal rejected CRA's argument.
  - CRA's position was contrary to the plain language of the statute, which requires an objective test based on hypothetical arm's length parties.
  - The proper analysis hinges on the price a hypothetical arm's length party would pay in the relevant transaction.
  - To recharacterize a transaction under 247(2)(b) and (d), CRA would have to show that no hypothetical party dealing at arm's length would enter into the relevant transaction.
    - In rejecting CRA's position, the Court agreed with the lower court's determination that any entity would be willing to give up a business opportunity for the right price.
- Beyond the plain language of the statue, CRA improperly ignored the Swiss Sub's separate corporate existence.
  - If CRA's interpretation of 247(2)(b) were upheld, then every Canadian corporation wanting to do business in a foreign jurisdiction through a foreign subsidiary would have to reallocate its foreign profits back to Canada.

- The government is now challenging Cameco's 2007-2013 tax years.
  - CRA made transfer pricing adjustments of more than C $5 billion, plus penalties.
  - On October 28, 2021, Cameco appealed CRA's determinations to the Tax Court of Canada.
  - Cameco argues that CRA is attempting to re-litigate its recent loss; CRA asserts that these new adjustments are unrelated.

Coca-Cola Co. v. Commissioner

- The primary issue involved the amount of royalties owed to Coca-Cola by six foreign licensees under intercompany licenses that permitted them to exploit trademarks and other intangible property rights
  - Coca-Cola advanced a CUT as its primary method, using master-franchise agreements involving well-known consumer trademarks
    - Master franchising is a business model in which a franchisor licenses its trademark, product formulations, and IP to a third party (the master franchisee). The foreign licensees operate at a similar intermediate level between Coca-Cola (the franchisor) and the bottlers (sub-franchisees)
    - Coca-Cola argued that application of its CUT analysis yields a royalty rate of 12.3% on concentrate sales. The result of this analysis is a profit split of 28.8% to the franchisor and 71.2% to the master franchisee
    - In addition to its master franchisee analysis, Coca-Cola used a residual profit split method to price the controlled transactions. The company split the residual profit using capitalized costs

Coca-Cola: IRS Adjustments

- The IRS determined an approximately 45% royalty using a CPM method based on income earned by unrelated Coca-Cola bottlers
  - Applying a "supply chain analysis," the IRS asserted that bottlers are compelling comparables for the foreign licensees because they (1) used the same intangible property, (2) performed similar manufacturing functions, (3) acquired similar local knowledge and performed similar customization, (4) faced similar risks, and (5) performed similar marketing activities and incurred similar marketing costs
- According to the IRS, the foreign licensees earned over $11 billion in operating profits, while Coca-Cola reported approximately $800 million in operating profits
- The IRS asserted deficiencies of over $3 billion for the 2007-2009 tax year

- Tax Court opinion issued in 2020, 155 T.C. 145 (2020)
- Held that the IRS did not abuse its discretion by applying the CPM using the bottlers as comparables and an ROA PLI to reallocate income to the Coca-Cola Group
  - J. Lauber: "In sum, we conclude that the Commissioner did not abuse his discretion in reallocating income from the supply points to petitioner by use of the bottler CPM. Petitioner has not carried its 'burden of showing that such determination was purely arbitrary.' … And because 'there is substantial evidence supporting the determination, it must be affirmed."
  - Reserved ruling on the Brazilian "blocked income" issue until an opinion is issued in *3M v. Commissioner*
    - In *3M* the taxpayer is challenging the validity of Treas. Reg. § 1.482-1(h)(2). The case is fully briefed and an opinion is forthcoming.

Coca-Cola: Motion for Reconsideration

- After the Tax Court issued its opinion, Coca-Cola filed a motion for reconsideration arguing that the IRS violated the company's due process rights
  - For 1987-1995, Coca-Cola and the IRS entered into a closing agreement using the "10-50-50" method. The closing agreement was executed in 1996.
  - Coca-Cola asserted that the IRS, by not endorsing the 10-50-50 method for 2007-2009, in essence "pulled the rug out from under" the company.
  - The Tax Court denied Coca-Cola's motion, and the company has indicated in public statements that this will be a focus of its appeal

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