Different Viewpoint Not a Misrepresentation: Tax Court Holds IRS Abused Its Discretion in Cancelling Eaton's APAs

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On July 26, 2017, the Tax Court ruled that the IRS abused its discretion when it retroactively cancelled two Advance Pricing Agreements (APAs) with Ohio electrical components manufacturer Eaton Corporation. APAs are rarely cancelled, and *Eaton v. Commissioner*, T.C. Memo. 2017-147, is the first court decision analyzing the propriety of such a cancellation. Under *Eaton*, the IRS may not cancel an APA on the basis of:

- A perceived material factual omission or misrepresentation during APA negotiations, when the taxpayer disclosed all information it reasonably believed relevant and responded thoroughly to all questions asked; or
- Immaterial and inadvertent APA compliance errors by the taxpayer that the taxpayer promptly reports and attempts in good faith to correct.

To protect APA benefits, taxpayers should make a good faith effort to present known facts during the APA process, to comply with the APA, and to correct any non-compliance when discovered.

Searching for Certainty

Eaton Corporation (Eaton) and its worldwide group manufacture, among other things, electrical breaker components, including at facilities in Puerto Rico and the Dominican Republic (the Island Plants). Until mid-2006, Eaton conducted operations at the Island Plants through a section 936 possessions corporation (EEPR) with Cayman subsidiaries. In mid-2006, EEPR's manufacturing assets were transferred to the Cayman subsidiaries, and a Swiss holding company wholly owned by Eaton acquired the subsidiaries' stock.

The Island Plants sold the breaker components they manufactured to related parties, for either distribution or incorporation into finished goods, and to unrelated parties, principally original equipment manufacturers. EEI, a first-tier, wholly-owned U.S. subsidiary of Eaton, engaged in at least three transactions with the Island Plants' operators: (1) it purchased breaker components from EEPR; (2) it licensed manufacturing intangibles to one of the Cayman subsidiaries; and (3) it received cost-sharing payments from that subsidiary for research and development.

Eaton and the IRS entered into an APA with respect to all three of these transactions for Eaton's 2001-2005 taxable years (APA I). The APA was renewed for 2006-2010 with respect to the first transaction only (APA II).[1] Both APA I and APA II established a transfer pricing method (TPM) for the sale of breaker components manufactured by the Island Plants to EEI.

[1] The IRS' National Office had reserved the right to make section 367(d) adjustments relating to Eaton's 2006 exit from its section 936 structure, taking the license off the table for APA purposes, and the sunset of section 936 had mooted the cost-sharing arrangement with the Cayman subsidiary.

Shooting the Messenger

In 2010, Eaton's tax department became aware that it had made several distinct, inadvertent errors in computing the TPM for the breaker component sales, resulting in inaccuracies in Eaton's APA Annual Reports and federal income tax returns. Some of the errors caused understatements of U.S. income; others resulted in overstatements. Eaton reported the errors to the IRS' APA office and consulted with the office as it investigated the errors, ultimately filing amended APA Annual Reports with technical explanations of the amendments, as well as amended federal income tax returns, for 2005-2009.

The IRS refused to accept the amended returns, and on December 16, 2011 advised Eaton by letter that it was cancelling APA I with effect from January 1, 2005, and APA II with effect from January 1, 2006. The letter cited myriad bases for cancelling the APAs, all generally falling into two categories: (1) material factual omissions and/or misrepresentations during the APA negotiations, and (2) lack of good faith compliance with the APAs. The IRS subsequently issued a deficiency notice increasing Eaton's 2005 and 2006 taxable income by $102 million and $267 million, respectively. Having cancelled the APAs, it based the adjustments on section 482 or, in the alternative, on section 367(d).

Losing the Battle…

The IRS claimed that, during APA negotiations, Eaton made material misstatements or omissions relating to nine separate subject areas. The Tax Court examined these allegations, as well as the IRS' audit of Eaton's 1994-1997 taxable years that prompted Eaton's request for APA I, in considerable detail. After an exhaustive review of the facts, the court dismissed the IRS' argument.

The court reasoned that Eaton had made good faith disclosures regarding matters it reasonably believed material to the APAs and fully responded to all questions posed. This, the court held, was enough. A taxpayer should not be expected to provide information that is not requested and that the taxpayer reasonably believes is unnecessary. The IRS had ample opportunity to seek additional information regarding the nine subject areas it cited. Its implicit hindsight conclusion that it had failed to conduct sufficient due diligence did not justify cancellation of the APAs.

Analyzing the IRS' claims regarding the APA negotiations required the court to interpret various terms and phrases in the applicable revenue procedures — Rev. Proc. 96-53 for APA I, and Rev. Proc. 2004-40 for APA II. Many of those terms and phrases appear near-verbatim in Rev. Proc. 2006-9 and its successor, Rev. Proc. 2015-41, which apply to most APAs currently in effect. For example, the court interpreted a "material fact" — defined in substantially similar manner as concerns cancellation of an APA in all four revenue procedures — as one that would have an impact on the agreed TPM. It also concluded that a "misrepresentation," a term undefined in the various revenue procedures, must be false or misleading, usually with the intent to deceive, and relate to the terms of the APA, to justify cancellation. The taxpayer's holding a different viewpoint from the IRS, the court concluded, is not the same as a making a misrepresentation.

The court also rejected the IRS' claim that Eaton's compliance errors justified cancellation of the APA. The court divided Eaton's compliance errors, which it characterized as "numerous," into three categories — errors in supporting data and computations, errors affecting the TPM computation, and other compliance errors — and analyzed them individually and in the aggregate.

The errors in supporting data and computations arose from a discrepancy in the standard costs included in two Eaton internal ledger systems and resulted in an overstatement of the transfer price for EEI's purchase of breaker products by approximately 5% for each of 2005 and 2006. Eaton attempted to rectify these errors once they became known, and the Tax Court held they did not represent a mistake of material fact or misrepresentation warranting cancellation of the APAs.

The errors affecting calculations under the TPM, while numerous, were likewise inadvertent, and they resulted, in the aggregate, in the overstatement of the transfer price by 2.5%, 0.3%, and 3.5% for 2005-2007, respectively, and an understatement of 0.9% for 2008. These errors, which did not consistently favor Eaton, did not merit cancellation of the APAs.

The court reached the same conclusion regarding certain book-tax differences, failure of a critical assumption, and the timeliness of the taxpayer's amended APA annual reports. The court found the IRS was aware of the book-tax differences reflecting year-end true-ups between Eaton's preliminary and final TPM computations because they were reported on Eaton's Schedules M and actively audited, and it held that the IRS could not complain when it had not asked Eaton to report or explain the particular differences in amended Annual Reports. With regard to critical assumptions, the court held Eaton's attempt to correct its APA Annual Reports and tax returns for data and computational errors did not constitute a change in its "methods of estimation" — the critical assumption the IRS contended Eaton had violated. Finally, although Eaton did file its amended APA Annual Reports for APA II after the deadline in Rev. Proc. 2004-40, the court found Eaton had earlier apprised the APA office of its correction efforts, had submitted the reports as soon as it had accurate information, and that in any event the APA office had advised in writing it did not request that Eaton submit such reports. Accordingly, none of these sundry alleged compliance errors justified cancellation of the APAs.

But Winning the War?

The IRS lost — decisively — and while a memorandum opinion is technically not binding on a future court, it may have collateral estoppel effect in the separate pending case involving Eaton Corporation's 2007-2010 tax years, in which nearly $900 million of section 482 adjustments are at stake.

Nevertheless, the case potentially has a silver lining for the IRS. In a 2013 pre-trial opinion, which is binding precedent, the Tax Court held that an APA is not a "contract," which would have placed the burden of revoking it on the IRS, and instead that an abuse of discretion standard applies to the IRS' cancellation of an APA. Although this didn't help the IRS in the Eaton case, the IRS presumably will have wider latitude to revoke APAs in the future. Eaton's motion for reconsideration of the "not-a-contract" determination was denied as moot on the day the final opinion came down.

Another important outcome of the case is that the IRS appears to have muffed its alternative section 367(d) argument for the 2005-2006 case: The court gave no credence to the IRS' *ipse dixit* assertion that the Island Plants' profitability levels, alone, demonstrated they had nonroutine intangibles, which they must have acquired from the U.S. group in a transfer to which section 367(d) applied. The court observed that the IRS had not specifically identified any transferred intangible or explained the exact value of any intangibles that should be covered by section 367(d). The 2007-2010 case may afford the IRS a second bite at that apple.

Lessons from *Eaton*

Eaton represents a victory for taxpayers, and for the certainty principle that motivates the APA process. Taxpayers can draw a number of lessons from the case:

- When negotiating an APA, make thorough disclosures regarding all facts reasonably believed material to the TPM and provide good faith and complete answers to all questions posed by the APA team. A taxpayer need not be a mind-reader: failure to hypothesize all questions the APA team *might* ask and volunteer information reasonably believed unimportant will not justify cancellation of its APA. There is no specific indication from the opinion that imperfect taxpayer due diligence is damning, but the opinion should not be viewed as a blank slate to turn a blind eye to potentially unhelpful information.

- Attempt in good faith to comply with all terms and conditions of the APA, file materially accurate and complete APA Annual Reports, and promptly inform the IRS upon becoming aware of reporting or other compliance discrepancies. The standard is not perfection: immaterial and inadvertent errors, even numerous ones, will not justify cancellation of an APA. Again, however, taxpayers should not take the court's liberality as license to engage in sloppy compliance activity.

- In the APA process, disclosure is the taxpayer's friend. Eaton's extensive evidence of its affirmative disclosures and complete responses to IRS due diligence questions, as well as its communications with the APA office after it discovered and investigated its compliance errors, won the case.

- But don't forget the foreign tax administration. The Eaton APAs were unilateral. A foreign tax administration (and court review) might be less forgiving.

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