TRANSFER PRICING – BANKRUPTCY COURT PREVENTS I.R.S. FROM PURSUING UNSUPPORTED TRANSFER PRICING CLAIMS; *IN RE: DeCoro USA, Limited, Debtor* (2014 U.S.T.C. PAR 50,227)

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Tags
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INTRODUCTION

A recent decision by the U.S. Bankruptcy Court, Middle District North Carolina (the "Court") provides interesting guidance on the practical application of U.S. transfer pricing rules. While one would not normally expect significant transfer pricing insight from a bankruptcy court, an I.R.S. claim for tax due caused the Court to apply U.S. tax transfer pricing rules in a surprisingly clear, concise and practical manner in order to determine the validity of the claim. In holding the claim invalid, the Court provided valuable guidance to taxpayers and the I.R.S. alike, finding that assertions of underpayment of tax in connection with the pricing of a controlled transaction must be based on the facts presented, rather than those imagined by the I.R.S.

BACKGROUND FACTS

The DeCoro Group was founded in 1997 by an Italian businessman whose goal was to produce high quality Italian leather furniture at affordable prices on a worldwide basis. In order to accomplish this, a Chinese manufacturing plant was purchased then expanded. Business management of the DeCoro Group was carried out by DeCoro Limited ("DCL"), a Hong Kong company. Strategic customer relationships with furniture retailers around the world were developed and maintained by DCL. Through a Chinese manufacturing facility, DCL was engaged in the manufacture and sale of high end leather furniture.

DeCoro USA ("DUSA") is a North Carolina company. It is a wholly-owned subsidiary of DCL. Furniture sales to customers in the U.S. – typically retail chains – were procured by DUSA, through its employees or independent sales representatives it engaged. DUSA acted under a distribution agreement with DCL. Under the agreement, the purported arrangement was one in which the furniture that it sold to customers in the U.S. was "purchased" from DCL. In doing so, DUSA "paid" DCL essentially the same amount that it charged the customers as the sales price of the furniture. It was entitled to a "commission" equal to cost plus 10%.

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During 2008 or early 2009, the I.R.S. began an examination regarding the U.S. tax liability of DCL and DUSA. The primary question during this examination was which company should pay the income tax due from furniture sales to customers located in the U.S. and depended upon which company should be regarded as the seller. If DUSA were a dependent agent of DCL, then the sales would be treated as having been made by DCL and it would be taxed as a foreign corporation making sales in the U.S. This was the primary position of the I.R.S. during the pre-petition audit. Conversely, if DUSA were an independent distributor, then the sales would be treated as having been made by DUSA and it would be liable for any income taxes due as a result of the domestic sales. This was the position of DUSA during the audit.

In February 2009, the I.R.S. issued an audit letter asserting that income taxes would be assessed against DCL based upon the furniture sales to customers in the U.S. However, prior to any assessment being made by the I.R.S., DCL filed an insolvency proceeding in Hong Kong and DUSA filed for bankruptcy relief in U.S. Bankruptcy Court. No further action was taken by the I.R.S. prior to filing its proof of claim in the bankruptcy proceeding.

The I.R.S. filed its proof of claim in June of 2009. The claim, as subsequently amended, asserted a tax deficiently of approximately $11.2 million including $1.8 million of pre-petition interest. The I.R.S. asserted that DUSA failed to report proper income, as required by I.R.C. §482, in its capacity as an independent distributor of DCL's products in the U.S. Under relevant provisions of U.S. tax law, the claim consisted of: (i) a primary adjustment that increased DUSA's operating margin for the audit period, thereby materially increasing its tax; and (ii) a secondary adjustment that reconciled DUSA's cash position to the I.R.S. assertion of greater income – a corporation that is taxed as if it received a greater amount of income must have paid a dividend to bring down its cash balance to the actual amount on hand. This resulted in an assessment of dividend withholding tax of 30% of the amount of deemed dividends. In a footnote to its proof of claim, the I.R.S. offered to reduce the secondary adjustment if DCL conceded it was taxable on the profits from sales in the U.S.

As is readily apparent, the basis for the proof of claim was inconsistent with the I.R.S. position in the examination, which resulted in a notice of proposed adjustment. However, given the two bankruptcy filings and the fact that DCL's situation involved Hong Kong liquidators, the I.R.S. chose what it perceived to be the path of least resistance for its claim; it chose to assert that DUSA was indeed a distributor and not a sales agent or facilitator. This approach forced DUSA to assert that DCL made the sales and that the cost plus arrangement was appropriate under principals of Code §482 for a facilitator of sales. The tactic also forced the Court to consider the merits of the I.R.S. and taxpayer flip-flop of positions ordinarily taken in this type of fact pattern.

BANKRUPTCY COURT HOLDING & RATIONALE

The Court disallowed the I.R.S. claim as filed, finding that DUSA was a facilitator of sales, not a distributor that purchased and sold inventory. In this regard, the Court noted that DUSA had taxable income whether it was a full-fledged, independent distributor of products purchased from DCL, as contended by the I.R.S., or was merely a facilitator or commissionaire as contended by DUSA. The issue was to determine the profit level that was appropriate to the functions actually performed.

The Court began by confirming the key components of a transfer pricing analysis as set forth in the tax regulations under Code §482 and the Internal Revenue Manual. These components are: (i) the application of the best method of transfer pricing, (ii) the specific factors in determining comparability, and (iii) the determination of the arms-length range. The Court had the benefit of expert testimony given for the I.R.S. and DUSA.

With advice of the experts, the Court examined the four step process required to select the best method of transfer pricing. These are: (i) the functional and risk analysis, (ii) the search for comparables, (iii) the determination of the arms-length range, and (iv) the determination of whether the transaction falls within the range that is determined. It was clear to the Court that the analysis of functions and risks was key to a proper transfer pricing analysis. DUSA's expert explained that the analysis determines the "value creation" of the tested party based on the relative assets employed and risks borne in the controlled transaction. Once value creation by the tested party is determined, the results of comparable companies and transactions can be identified and the most reliable arms-length result can be reached by applying the best method.

The Comparative Profits Method ("CPM") was determined to be the best method of transfer pricing by both the taxpayer and the I.R.S. CPM evaluates transfer pricing by reference to objective measures of profitability, referred to as profit level indicators ("PLI's"), generally expressed in percentage terms. DUSA's expert characterized DUSA as a service provider rather than a distributor. His report stated that:

> [T]he profits of entities that have as a main focus maximizing sales turnover should generally be compared under the CPM using a PLI with sales in the basis…entities that are primarily service providers [such as DUSA] incur operating expenses as a result of their value adding activities and so generally should be compared under the CPM using operating expenses in the base of the PLI.

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In its paper work, the I.R.S. chose operating margin as the most reliable profit level indicator. Operating margin is a measurement of the proportion of a company's revenue that is left over after paying for variable costs of production such as wages and raw material. It is determined by dividing the operating income before interest and taxes by net sales. However, at trial, both the I.R.S. and DUSA applied the "Berry Ratio" as the proper PLI. The Berry Ratio is the ratio of a company's gross profits to its operating expenses. In other words, the selected denominator of the Berry Ratio is operating expenses. Thus a comparable which had a profit of 100 and operating expenses of 90 would have a Berry Ratio of 1.11 (calculated as profits over operating expenses or 100/90).

The key is to identify the appropriate group of comparable companies so that the Berry Ratio can be applied properly. Here DUSA used one set of comparables – service providers – and the I.R.S. used a different set – distributors. It then applied the typical presumption of correctness in transfer pricing cases, viz., the I.R.S. transfer pricing adjustment may not be overturned unless it is arbitrary, capricious or unreasonable. On the facts before it that were related to the functions and risks taken on by DUSA, the Court held that the I.R.S. assertion was arbitrary and capricious because it ignored the activity of the tested party and was based primarily on the terms of an agreement that was less than pristine.

According to the Court, the functions and risks assumed by DUSA were consistent with the limited role of a service provider that facilitated sales. It was nothing like the functions and risks of the value add distributors that formed the basis of the I.R.S. adjustment. Consequently, benchmarking to service type companies such as freight forwarders was appropriate. In comparison, the I.R.S. benchmarked to full-fledged distributors having functional responsibilities and risks for inventory, logistics, credit, and product warranties. DUSA never took title to inventory, had minimal customer contacts, never concluded contracts, and never set sales prices. The Court pointed out that one of the cardinal rules, embodied in the I.R.S. regulations under Code §482, is that intercompany agreements which do not represent the substance of the transactions are not controlling for transfer pricing purposes. In this regard, the Court took judicial notice of phrases used by the I.R.S. in its notice of proposed adjustment, such as "commissionaire" and "representative of the principal" to describe DUSA as a dependent agent of DCL. The I.R.S. could not characterize DUSA in that limited fashion and then change its characterization to a full-fledged distributor without point to specific facts other than the agreement.

CONCLUSIONS

The case illustrates several key points to be considered in the development and implementation of proper transfer pricing, from both the taxpayer and I.R.S. perspective. Many of these points can be taken from language in the case itself.

1. Align transfer pricing strategy for tax purposes with the enterprise's business model: The Court accepted the description of DUSA's functions and risks given by U.S. senior management and was convinced that DUSA "had no autonomy or independence and effectively no discretion regarding matters relating to furniture sales." This testimony was given without objection and was key to the functional and risk analysis which was the basis of DUSA's transfer pricing position.

2. Monitor written intercompany agreements and amend them if necessary to reflect changes in the business: There were inconsistencies between the terms and conditions of the distribution agreement and the way DUSA interfaced with DCL. The distribution agreement provided the I.R.S. with an opportunity to argue that DUSA was operating as a full-fledged distributor. While this was ultimately disproved, a full hearing before the Court was required before the matter could be sorted out.

3. The quality of a transfer pricing analysis depends on the quality of the comparables: The comparables selected by the I.R.S. did not match the functions and risks of DUSA. This was fatal to analysis supporting the I.R.S. position.

4. Know the comparables: Related to point 3, one should know why a given comparable company has been selected and how that company's functions and risk relate to the tested party's functions and risks. The I.R.S. analysis of comparables was based on brief excerpts of 10-K reports and did not

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exhibit sufficient knowledge of how the comparable companies conducted their business.

5. Substance trumps writing: Substance eventually should control regardless of the content of written agreements, policies or procedures that are simply not followed.

6. Profit Level Indicators are important: The PLI's are key to proper application of the CPM. They focus the CPM analysis on the specific component of the value chain that reflects the economics of the controlled transaction. This enables a separate analysis of transfer pricing without undue consideration of business conditions that affect overall profitability of the tested party but which are unrelated to transfer pricing itself.

7. Hold the I.R.S. accountable: In sum, the I.R.S. deserved what it got. It took inconsistent positions in its notice of proposed adjustment and the principal arguments for its bankruptcy claim. The I.R.S. allowed its expert to conduct a faulty transfer pricing analysis and based the argument for its claim on that faulty analysis. In its own way, the I.R.S. departed from its own "substance over form" rules by limiting its factual submission to the contents of the distribution agreement while ignoring input provided by business management, the independent bankruptcy liquidator, and empirical business data (e.g., invoices, customs, customer contracts, warehousing, capital expenditures, and general ledgers).

Finally, there is a troubling aspect to this case from an I.R.S. tax administration standpoint. The case came to trial in September 2013. Both parties were permitted to file additional briefs. The additional briefs were also reviewed by the Court and considered along with all other arguments, testimony, evidence, etc. in its March 18, 2014 decision. Simultaneously with these developments, the I.R.S. had been rolling out its Transfer Pricing Operations ("T.P.O.") group and its new, more robust transfer pricing audit strategy, as detailed in the February 2014 Transfer Pricing Audit Roadmap and the quality examination process ("Q.E.P."). The process entails a "working hypothesis" and upfront identification and prioritization of transfer pricing issues. The accuracy of the notice of proposed adjustment, and the continued development of facts relevant to the remaining audit process and beyond have been noted as key components of these initiatives. If the I.R.S. performance in the this case is any indication of the way these initiatives are being carried out in practice, taxpayers fears regarding I.R.S. behavior may appear justified.