TRANSFER PRICING POSITIONS OF CONSOLIDATED GROUPS: AFTER *GUIDANT*

Authors
Michael Peggs
Kenneth Lobo

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You may recall a particularly memorable Inspector Clouseau dialog from the 2006 remake of film *The Pink Panther*, with Steve Martin cast in the role of Inspector Jacques Clouseau. It goes like this:

> CLOUSEAU. It's amazing how he fell perfectly into the chalk outline on the floor.
>
> PONTON. I think they drew the outline after he was shot.
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> CLOUSEAU. Ah! We must be working with some kind of mastermind!

The exchange seems fitting for a discussion of the Tax Court decision in *Guidant LLC, et al. v. Commr.*, where the court held that, at law, a single application of the comparable profits method ("C.P.M.") can be used to determine the true consolidated taxable income resulting from multiple controlled transactions of various types concluded by multiple members of a U.S. controlled group of companies.

So, was the victim (the consolidated taxpayer) fitted into a chalk outline already drawn on the floor by the I.R.S.? In this article, we ask the Clouseau-esque question: Was this outcome the the work of a mastermind?

GUIDANT CASE

The facts in *Guidant* are straightforward.[1] The taxpayer was an affiliated group that filed a consolidated tax return. Various group members consummated transactions with foreign affiliates. Instead of rendering specific adjustments to each subsidiary's separate taxable income ("S.T.I."), the I.R.S. determined the group's true consolidated taxable income ("C.T.I.") by posting one adjustment to the entire group. The I.R.S. did not make adjustments related solely to tangible, intangible, or services income – despite the fact that those items of income were obvious in the transactions. The taxpayer asserted that

- the I.R.S. adjustments were "arbitrary, capricious, and unreasonable"[2] as a matter of law because the I.R.S. did not determine the "true taxable income" of each controlled taxpayer as required by the regulations, and
- the I.R.S. did not make specific adjustments with respect to each transaction involving the use of an intangible, a purchase and sale of tangible property, or a provision of services, also as required by the regulations.

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1 *Guidant LLC f.k.a. Guidant Corporation and Subsidiaries, et al. v. Commr.*,146 T.C. No. 5 (Feb. 29, 2016).

2 Treas. Reg. §1.482-1(f)(1)(iv).

To the first argument, the I.R.S. noted that it would be too costly for it to extract each individual member's information at the time of audit. Further, according to the I.R.S., the taxpayer was uncooperative in providing detailed information related to the S.T.I. of each group member. The court noted that the I.R.S. should determine a consolidated group's taxable income only after determining each individual member's true taxable income to ensure accuracy. However, the court noted that it would not force the I.R.S. to do so where it would "…eliminate the Commissioner's ability to make Section 482 adjustments when a taxpayer consciously withholds or fails to maintain records information necessary for S.T.I. adjustments." The court held that determining whether the I.R.S. proceeded in an "arbitrary, capricious and unreasonable" manner depends on specific facts. Here, the I.R.S. asserted that the taxpayer was uncooperative with the I.R.S., and for that reason, the approach of the examiner was reasonable. This matter was left for a trier of fact to determine at trial.

As to the second argument, the judge noted that, as a matter of law, the I.R.S. may aggregate transactions involving tangibles, intangibles, and services when doing so provides the best means of determining the true taxable income of a controlled taxpayer. The I.R.S. is allowed to make one adjustment to a consolidated group while ignoring the individual transactions within the group but only if the amount represents the true taxable income of the taxpayer. Whether the amount calculated by the I.R.S. was accurate must be determined by a trier of fact at trial. The C.P.M., as defined in Treas. Reg. §1.482–5, may be used to evaluate the arm's length price for controlled transactions of various types, including transfers of tangible and intangible property, and services. The C.P.M. is also widely used in the application of the residual profit split method to allocate income to the routine contributions of the relevant parties.[3] The C.P.M. is the workhorse of U.S. transfer pricing, much as its O.E.C.D. cousin, the T.N.M.M. (Transactional Net Margin Method), is the workhorse of controlled transaction pricing in the rest of the world.

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THE COMPARABLE PROFITS METHOD

While the C.P.M. is referenced in the respective Treasury regulation sections concerning the approach to pricing different types of controlled transactions, only Treas. Reg. §1.482–5 sets out the rules in detail for the proper application of this method in coordination with the more general requirements of Treas. Reg. §1.482–1(c) applying the best method rule and Treas. Reg. §1.482–1(d) addressing comparability. The C.P.M. is defined as follows:

> The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability [profit level indicators] derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.[4]

In the foregoing, the term "controlled transaction" is singular, and a standard of comparability is established with respect to the business activities and circumstances that characterize the controlled transaction. On the basis of this definition, the C.P.M. appears to be a method that is applied by transaction.

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[3] Treas. Reg. §1.482–6(c)(3).

[4] Treas. Reg. §1.482–5(a).

Under the C.P.M., the determination of an arm's length result is based on "the amount of operating profit that the tested party would have earned on related party transactions."[5] Measurement of this operating profit is to be carried out with reference to the "tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity)." Whether all members of the consolidated group may be treated as the tested party for the purpose of calculating operating profit depends in large part on the availability of reliable data and whether this calculation can be carried out using a relatively small number of reliable adjustments. If a particular application of the C.P.M. cannot meet these requirements, there is a diminished likelihood of achieving a good standard of comparability and of being able to conclude that the C.P.M. is the best method.

In practice, it would appear that the I.R.S. lacked information needed to apply the C.P.M. transactionally. While it may be the case that the lack of transactional analysis was excusable, owing to a failure on the part of the taxpayer to provide information during the course of the examination, the question remains whether the C.P.M. can be the best method as a matter of law when applied using an undifferentiated measure of operating profit earned both from related party transactions and other irrelevant business activity.

SECTION 482 ADJUSTMENTS

In general, the I.R.S. has the authority to make allocations to any case where the transfer price between a controlled party is deemed not to be at arm's length.[6] To make an adjustment, the I.R.S. neither has to show a taxpayer's intent to evade taxes nor demonstrate that there is a taxable realization event. However, once an adjustment is made, the I.R.S. must apply the arm's length standard, even if the result is favorable to the taxpayer.[7]

Once an adjustment is made, the taxpayer bears the burden of demonstrating that the I.R.S. is incorrect by establishing that the stated price is at arm's length and that the I.R.S. determination was arbitrary, capricious, or unreasonable.[8] If the taxpayer does not establish the arm's length price, a court will determine the arm's length price on its own.[9] Readers should note that the burden of proof remains with the taxpayer. Should the taxpayer not present enough evidence to demonstrate that the I.R.S. adjustment is arbitrary, capricious, or unreasonable, the I.R.S. determination will not be overturned.

The taxpayer can discharge its burden of persuasion by establishing that the I.R.S. allocation (i) is based on erroneous assumptions regarding the property and business or related persons, (ii) reflects significant errors in developing the arm's length

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5 Treas. Reg. §1.482–5(b)(1). The tested party is the participant in the controlled transaction.

6 Treas. Reg. §§1.482-1(a)(2), (f).

7 *Pikeville Coal Co. v. U.S.*, 37 Fed. Cl. 304 (Ct. Cl. 1997).

8 *Searle, G.D. & Co v. Commr.*, (1987), 88 T.C. 252. *United States Steel Corp v. Commr.*, 45 AFTR 2d 80-1081 (CA2, 1980)

9 Veritas Software Corp & Subsidiaries, et al. v. Commr., 133 T.C. 297 (2009).

price from uncontrolled transactions, or (iii) is otherwise contrary to the regulations.[10]

CONSEQUENCES

The decision on the partial summary judgment motion in *Guidant* implies that the C.P.M. must work both for and against the I.R.S. in the case of an affiliated group filing a consolidated tax return. This approach makes it possible for U.S. consolidated groups to use the C.P.M. to both lower or raise the profit resulting from an aggregation of controlled transactions. Thinking more broadly, and especially in the event that the Tax Court finds at trial that the I.R.S. was not arbitrary and capricious when it applied the C.P.M., double taxation cases may never be the same again.

"Taxpayers must be diligent in keeping records of communications with the I.R.S. to avoid being deemed 'uncooperative.' . . . Compliance with I.R.S. response deadlines for I.D.R.'s tends to support cooperation and justify possible deficiencies in th responses."

Consider a circumstance in which a foreign tax authority makes an adjustment to the transfer price used in an intangible asset transaction between a foreign subsidiary and its U.S. parent that is itself a part of a U.S. affiliated group. Suppose the foreign tax authority uses a profit split method to calculate its adjustment. Suppose further that the U.S. parent entity has considerable net operating losses. Ordinarily, the relevant profit to be divided using the profit split method is the profit earned by the transaction participants. The foreign adjustment appears to have little merit because there is no combined profit (assuming the U.S. loss exceeds the foreign profit).

On the other hand, if the profit to be divided is the C.T.I. of the U.S. affiliated group and the foreign subsidiary, the foreign adjustment may appear to have greater merit. Here, the U.S. tax base is harmed, contrary to the intent of the Court in the *Guidant* decision, because an unprofitable S.T.I. has been turned into a profitable C.T.I. Moreover, the outcome of applying the C.P.M. by using the C.T.I. in the U.S. and the profit split method abroad closely approximates the result that is reached under a formulary apportionment method – similar to California unitary taxation.[11]

While we must wait for the outcome of the trial to determine whether the fate of Treas. Reg. §1.482–5 is to fall into a chalk outline, we can learn two immediate lessons from *Guidant* at this stage.

The first is that withholding information from the I.R.S. or providing information that is insufficiently detailed during the course of a transfer pricing examination is not advisable, given that a defense based on the facts may not be possible at trial. As a result, taxpayers may become more cooperative in order to avoid an unfortunate finding at the affiliated group level. Taxpayers must be diligent in keeping records of communications with the I.R.S. to avoid being deemed "uncooperative." Should the case proceed to trial, factual determinations at trial will aid practitioners in determining when clients are being "uncooperative" when providing information to the I.R.S. Compliance with I.R.S. response deadlines for information and document requests ("I.D.R.'s") tends to support cooperation and justify possible deficiencies in the responses.

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10 *American Terrazzo Strip Co Inc. v. Commr.*, 56 T.C. 961, acq 1973-2 CB 1 (1971); *Altama Delta Corp. v. Commr.*, 104 T.C. 424 (1995); *Veritas*, 133 T.C. 297 (2009).

11 Formulary apportionment has been rejected by the 2015 B.E.P.S. Project reports, now being incorporated into domestic legislation and administrative practice.

The second lesson is that a clearly documented account of how the C.P.M. has been applied in a transactional manner is essential in order to be able to defend this position when settling double tax cases.

The taxpayer may argue that the I.R.S. used an incorrect comparable, or comparables, when determining the true taxable income, since it was unlikely that the comparable used was determined in accordance with the methods prescribed for all income types (tangible, intangible, and services). Since an incorrect comparable is likely unreliable, the arm's length price determined by the I.R.S. on the basis of that comparable would likely be unreliable, also. In those circumstances, factual grounds support a taxpayer contention that the I.R.S. proceeded in an arbitrary, capricious, or unreasonable manner