EATON A.P.A. CANCELLATIONS WERE AN ABUSE OF I.R.S. DISCRETION

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INTRODUCTION

As the transfer pricing travails of Eaton Corporation ("Eaton") continue, a recent U.S. Tax Court decision affirmed that (i) I.R.S. administrative rules set down in revenue procedures and relied upon by the I.R.S. and a taxpayer cannot be arbitrarily circumvented and (ii) the I.R.S. must reasonably exercise its discretion.

At issue was the cancellation of two advance pricing agreements ("A.P.A.'s") and the consequent I.R.S. income adjustments made as a result of applying a different transfer pricing method. Eaton's position was that the A.P.A.'s were binding contracts and that these contracts were cancelled for reasons other than those named as cause for termination in the respective A.P.A.'s. Though the Tax Court did not agree with Eaton that an A.P.A. should be interpreted under contract law, the Tax Court carefully reviewed the circumstances of the cancellation against Rev. Proc. 96-53 and Rev. Proc. 2004-40, which govern the drafting and administration of A.P.A.'s in the relevant tax years.

BACKGROUND

An A.P.A. is an alternative to the traditional adversarial model between a taxpayer and one or more tax authorities. Its purpose is to reach an agreement concerning the transfer pricing method to be used for a number of tax years in one or more controlled transactions.

A.P.A.'s take a long time to negotiate, owing both to the fact-intensive nature of transfer pricing matters and the considerable due diligence both sides must undertake. Both sides must be prepared to compromise technical positions somewhat in order to obtain practical transfer pricing certainty. Once concluded, an A.P.A. is signed and a program of annual review is undertaken to ensure that the terms of the A.P.A. are followed. For transfer pricing positions that influence a large share of a tax provision, or a significant transfer pricing position that is complex or unique, generally accepted convention holds that is it better to spend the time and fees for two years negotiating an A.P.A. than to spend an even greater amount to produce Treas. Reg. §1.6662-6 documentation and manage examinations, appeals, competent authority intervention, and litigation.

Currently, the administrative procedures for requesting and administering an A.P.A. are set out in Rev. Proc. 2015-41. As with any agreement, the hallmarks of a successful A.P.A. are (i) negotiation in good faith, (ii) disclosure of all material or relevant facts or documents, (iii) disclosure of true facts or documents, and (iv) adherence to the terms of the agreement over the duration of the agreement's lifespan.

ANALYSIS

In the case at hand, the I.R.S. alleged "failure of a critical assumption, misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the A.P.A."[1] as among the "numerous reasons" for the cancellation of the Eaton A.P.A.'s. The Tax Court weighed each claim, finding in favor of Eaton in the case of all stated reasons for cancellation.

The origin of the dispute was a series of inadvertent accounting errors committed by Eaton accounting and tax personnel and discovered only after a new transfer pricing manager joined the company and looked *de novo* at the calculations and underlying information used to comply with the terms of the A.P.A.'s. Many of these errors did not result in a favorable tax outcome for Eaton, though in net terms the transfer prices were higher as a result by approximately 5% in each of the 2005 and 2006 tax years.

Eaton alerted the I.R.S. to these discrepancies, filed Forms 1120X to report the additional income, and prepared to update its annual A.P.A. reports to explain the effect of the errors. In response, the I.R.S. changed its view concerning the transfer pricing method in negotiations of a third A.P.A., advised Eaton not to file updated A.P.A. reports, and issued a letter cancelling the A.P.A.'s covering tax years 2001-2009.

The extensive information gathering and questioning that occurred during the first and second A.P.A. negotiations, as well Eaton's responsiveness and cooperation, proved to be a large part of the undoing of the I.R.S. case. Many items of information that were alleged to have been omitted or neglected by Eaton in an act of bad faith bargaining were found to have been disclosed during A.P.A. negotiations or, alternatively, could have been discovered by the I.R.S. during its many series of questions or meetings.

In its analysis, the Tax Court concentrated *inter alia* on the interpretation of the terms "material fact", "critical assumption," and "misrepresentation" in the context of the Eaton facts, finding that the conditions for the cancellation of an A.P.A., as set out in the revenue procedures, were not met. It was noted that either side could have walked away during either of the two A.P.A. negotiations if viewpoints concerning the best transfer pricing method differed significantly enough and that the I.R.S. signing of two largely similar A.P.A.'s limited its ability to argue in retrospect for a different transfer pricing method.

CONCLUSION

The *Eaton* case outcome highlights the complexities of implementing a transfer pricing method once the "transfer pricing study" is complete, especially when accounting and enterprise information systems are used to store information and generate reports to be used in tax calculations.

The 202-page Tax Court memo explains in considerable detail the data warehousing procedures used by Eaton to store report templates and files, the ledgers and

[1] *Eaton Corporation and Subsidiaries v. Commr.* T.C. Memo 2017-147, p. 112.

“mirror ledgers” used to record transfer prices for accounting purposes and eliminate intercompany transactions on consolidation, and the sources of information used to calculate ratios and cost variance factors critical to the compliance with the A.P.A. terms. It was the fact that many data sources had to connect across group companies using the intervention of controllers and tax personnel that supported the finding of “human error” or “computational error” rather than deliberate misrepresentation or deceit. Even with an audit opinion on the non-consolidated financial statements of the Eaton entities relevant to the A.P.A.’s, the calculation errors slipped by the taxpayer and the I.R.S. at successive annual reporting checkpoints.

While this decision offers some relief for companies with pending or in-force A.P.A.’s or competent authority settlements, it also illustrates the value of proper transfer pricing policy implementation and the engagement of employees and advisors outside of the tax function to make sure the system works reliably from the start. Personnel entrusted with key information or process control can change jobs unexpectedly or eventually retire. Initial engagement of all people needed to produce results representing true taxable income is critical, as is a periodic check to ensure that the system is performing as expected.

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Finally, the *Eaton* case serves as a reminder of the possible unfortunate consequences of fixing mistakes, even honest mistakes, in a climate of heightened suspicion of tax avoidance among tax authorities.