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Global Tax Alert

News from Transfer Pricing

US Tax Court holds no Section 6662 penalties after IRS abused discretion in canceling APAs

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On 28 October 2019, the United States (US) Tax Court determined in *Eaton Corp. & Subs v. Commissioner*, 153 T.C. No. 6 (2019) (*Eaton III*), that a corporation is not liable for penalties under Internal Revenue Code Section 6662 for income tax adjustments made under court rules as part of a 2017 decision in which the Court held that the Internal Revenue Service (IRS) abused its discretion in canceling two advance pricing agreements (APAs). In this latest decision, which supplements the 2017 decision, the Court concluded that the penalties do not apply because the adjustments in the earlier decision were not made under Section 482.

Background

Taxpayer had two APAs addressing its transfer pricing methodologies, one for tax years 2001–2005 (APA I) and one for 2006–2010 (APA II). In 2011, the IRS determined that Taxpayer had not complied with the terms of the revenue procedures related to APAs, and canceled APA I and APA II, effective 1 January 2001, and 2006, respectively. After canceling the APAs, the IRS made Section 482 adjustments to Taxpayer's income. Based on its determinations, the IRS issued notices of deficiency for approximately US$20 million and $55 million – and corresponding Section 6662(h) penalties of $14 million and $37 million – for tax years 2005 and 2006, respectively.

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In an initial 2013 decision, *Eaton Corp. & Subs. v. Commissioner*, 140 T.C. 410 (2013) (*Eaton I*), the Tax Court held that its deficiency jurisdiction extended to reviewing the cancellation of the APAs, because they are administrative determinations necessary to determine the merits of the deficiency determinations.

In a subsequent 2017 decision, *Eaton Corp. & Subs. v. Commissioner*, T.C. Memo. 2017-147 (*Eaton II*), the Tax Court held that it was an abuse of discretion for the IRS to cancel the APAs. In *Eaton II*, the Court stated that its decision would be entered under Tax Court Rule 155, which allows the parties to submit computations showing the correct amounts to be included in the decision in accordance with the court's findings. The parties, however, were ultimately unable to agree on the computations. Specifically, one issue remained in dispute: the imposition of penalties under Section 6662(h).

Opinion

The Court explained that the Rule 155 process is not intended to be a forum for raising new issues but rather a means for allowing for computations in accordance with the court's findings. The Government contended that Section 6662(h) penalties were not a new issue, because the IRS had asserted the penalties in the notices of deficiency that it issued based on its Section 482 adjustments. In contrast, Taxpayer argued that the penalties were a new issue in the computations under Rule 155, which, Taxpayer contended, were not Section 482 adjustments.

The Court determined that it need not decide whether the imposition of Section 6662(h) penalties was a new issue for purposes of Rule 155; regardless of whether it is a new issue, there were no Section 482 adjustments to support the imposition of Section 6662(h) penalties. The Court explained that the IRS originally asserted the Section 6662(h) penalties based on its Section 482 adjustments, which the IRS calculated following its cancellation of the APAs. Because the Court held in Eaton II that the IRS abused its discretion by canceling the APAs, however, the APAs remain in effect for the years at issue. Accordingly, the Court concluded, there were no Section 482 adjustments, so Taxpayer is not liable for corresponding Section 6662(h) penalties.

Implications

This series of cases has limited applicability to other taxpayers. The IRS has rarely attempted to cancel an APA. Moreover, the facts in *Eaton II* are precise and particular to this taxpayer; taxpayers must be careful not to apply the conclusion in this case generically to any scenario in which an APA is cancelled.

It is unlikely that a taxpayer will find itself in a scenario similar to the petitioner in these cases. For the holding in *Eaton III* to apply, a court would first have to decide that, although adjustments were made under Rule 155, they were not Section 482 adjustments, so a Section 6662(h) penalty was inappropriate.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Currency references in this Alert are to US$.

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