22 August 2019

Global Tax Alert

News from Transfer Pricing

United States Court of Appeals affirms Tax Court's decision in Amazon case

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

The United States (US) Court of Appeals for the Ninth Circuit (the Court of Appeals) released on 16 August 2019, its opinion in *Amazon.com, Inc. & Subsidiaries v. Commissioner* (the Opinion). Ruling on the Commissioner's appeal, the court affirmed the Tax Court's decision of 23 March 2017.[1] In that decision, the Tax Court concluded that, under the then applicable transfer pricing regulations, the definition of "intangible" does not include residual business assets, such as the value of employees' experience, education and training (known as "workforce in place"), a culture of innovation, going concern value, goodwill and other unique business attributes and expectancies (which the parties refer to as "growth options"). The Court of Appeals went out of its way to point out that its Opinion interprets the definition of "intangible property" under the transfer pricing regulations promulgated in 1994 and 1995 and not the subsequently issued 2009 regulations or the statutory amendment introduced with the *Tax Cuts and Jobs Act of 2017* (TCJA).

Detailed discussion

Background

In 2005, Amazon.com, Inc. (Amazon US) entered into a cost-sharing arrangement with its Luxembourg subsidiary (Amazon Lux), granting Amazon Lux the right to use certain pre-existing intangible property (IP) in Europe.

Building a better working world

Under the terms of the agreement (and under the applicable transfer pricing regulations), Amazon Lux had to make an upfront "buy-in payment" for the pre-existing IP. Amazon US initially reported a buy-in payment of US$255 million. The Commissioner of the Internal Revenue Service (IRS), having concluded upon audit that the buy-in payment was not determined at arm's length, performed its own calculation and valued the buy-in at US$3.6 billion. Amazon disagreed and petitioned the Tax Court, which held that the IRS's determination of the cost-sharing buy-in payment was arbitrary, capricious, and unreasonable. The Commissioner took the matter to the Court of Appeals.

Analysis

The Opinion, which interpreted the now outdated 1994/1995 transfer pricing regulations, turned on whether the definition of intangibles was broad enough to include all intangible assets of value; specifically, on whether the "buy-in" required for "pre-existing intangible property" must include compensation for residual business assets, such as workforce in place, going concern value, goodwill and growth options. The Court of Appeals reviewed the Tax Court's conclusions of law under the applicable de novo standard.[2]

To answer this legal question, the Court of Appeals considered the regulatory definition of an "intangible," the overall transfer pricing regulatory framework, the rulemaking history of the regulations, and whether the Commissioner's position was entitled to deference under *Auer v. Robbins, 519 U.S. 452* (1997).

a. Definition of an intangible

By reference to 26 USC Section 936(h)(3)(b), the applicable regulations define "intangible" as an asset that both "has substantial value independent of the services of the individual" and is one of the items, listed in Treas. Reg. Section 1-482(4)(b)(1)-(6), which includes 28 specific items, as well as a catchall category of "other similar items." According to the Opinion, an item is considered similar to the 28 specific items "if it derives its value not from its physical attributes but from its intellectual content or other intangible properties." The Court of Appeals inferred from this provision and the introductory language of the definition that residual-business assets are intangibles if they (1) have substantial value independent of the services of any individual and (2) derive their value from intellectual content or other intangible properties. The Commissioner argued that both of those elements were satisfied. Amazon argued that the Commissioner's interpretation of the catchall provision was too sweeping, practically rendering the enumeration of the 28 items superfluous. It further argued that other items should only be considered similar if they are of the same kind as the enumerated items and that the common denominator of the 28 items is that they can be sold independently. The Court of Appeals did not fully accept Amazon's argument and instead concluded that the analysis of the regulatory text alone does not definitively resolve the matter at issue, as it is not self-evident whether assets, such as "growth options" or "culture of innovation," meet the first requirement.

b. Regulatory framework

The Court of Appeals disagreed with the Commissioner's argument that Treas. Reg. Section 1.482-7A supports the view that the definition of "intangible" includes residual-business assets, even though such assets generally cannot be transferred independently from the business. The Commissioner additionally argued, based on the preamble of Treas. Reg. Section 1.482-1, as interpreted by relevant case law, that anything of value made available between related parties must be paid for in the buy-in, regardless of whether it is defined as an intangible, because that's what uncontrolled parties would do if they entered into the same transaction under the same circumstances. According to the Opinion, the Commissioner's argument assumed, but did not explain why, a cost-sharing arrangement is more akin to the sale of business than to a partnership in certain assets or aspects of the business.

The Court of Appeals pointed out that the regulations describe a cost-sharing arrangement as an agreement "to share the costs of development of one or more intangibles," thus identifying intangibles as being the product of research and development efforts. This description seemed to exclude from the meaning of "intangibles" assets such as goodwill and going concern value, which are generated by earning income and not by incurring costs. Additionally, the Opinion differentiated between intangibles that are generated by earning income, such as going concern and goodwill, from intangibles that are generated by incurring deductions/ making investments in the asset.

Consequently, the Court of Appeals concluded the regulatory scheme does not definitively resolve the issue, but it favors Amazon more than the Commissioner.

c. Rulemaking history

The Court of Appeals further concluded that the drafting history of the transfer pricing regulations strongly supports Amazon's position that Treasury intended to limit the definition of "intangible" in the 1994/1995 transfer pricing regulations to independently transferable assets. It cited Treasury's request for comments from 1993 inquiring specifically on whether the definition of intangibles should be "expanded" to include items not normally considered to be IP, such as work force in place, goodwill or going concern value. The Court of Appeals additionally pointed to the drafting history of Treas. Reg. Section 1.482-4, specifically because the temporary regulations in 1993 defined "intangible" as "any commercially transferable interest," but that language was taken out because it was considered superfluous.

d. The Auer deference

Finally, the Court of Appeals disagreed with the Commissioner's argument that the Tax Court should have deferred to the IRS's interpretation of its own regulations (also referred to as Auer deference). The Court of Appeals, relying on applicable case law, concluded that the first announcement of an agency's first interpretation is dispositive on whether the agency's view will be given Auer deference. In this case, the Court of Appeals pointed out, the Commissioner was not able to identify a specific document definitively expressing the agency's view, thus making the court documents in the present case the first announcement of such view. Therefore, the interpretation was held not entitled to deference.

e. Footnote 1

In a footnote at the beginning of its Opinion, the Court of Appeals explicitly stated that, if the case were governed by the 2009 regulations or by the 2017 statutory amendment of the TCJA, the Commissioner's position would undoubtedly be correct.

Implications

The Opinion interprets the outdated 1994/1995 transfer pricing regulations, but also offers several insights for taxpayers that go beyond their temporal scope. The statement in Footnote 1, in which the Court of Appeals expresses support for the Commissioner's position if the case were governed by the post-2009 regulations, may be considered dicta and thus not legal precedent, but taxpayers should still consider the potential implications on post-2009 cost-sharing arrangements.

In 2009, Treasury issued temporary regulations broadening the scope of what is included in the buy-in payment upon entering a cost-sharing arrangement. Previously, a buy-in payment had to include "pre-existing intangibles" defined by Treas. Reg. Section 1.482-4. Under the 2009 temporary regulations, a buy-in payment must include a "platform contribution" defined by Treas. Reg. Section 1.482-7(c)(1). A platform contribution is defined as any resource, capability or right that is reasonably anticipated to contribute to developing cost-shared intangibles. Although there is little guidance on what assets of value constitute a platform contribution other than pre-existing intangibles, the 2009 regulations incorporate valuation methodologies – including the income method and the acquisition price method – that appear designed to capture residual value. This Opinion may challenge the binary view of residual business assets as either falling within Internal Revenue Code (IRC) Section 936(h)(3)(B) or not, and prompt taxpayers to further review their facts and circumstances related to post-2009 transactions.

In the TCJA, Congress amended the definition of intangible property set forth in IRC Section 936(h)(3)(B) to explicitly include workforce, goodwill and going concern. While the Opinion clearly differentiates its conclusions from subsequent rule changes, there are potentially three separate periods of guidance for taxpayers to consider as they evaluate the impact of the Opinion on their specific facts and circumstances.

Endnotes

1. See EY Global Tax Alert, *US Tax Court holds IRS was arbitrary, capricious and unreasonable in determining Amazon subsidiary's buy-in payment*, dated 28 March 2017.
2. Under this standard, the appellate court acts as if it were considering the question for the first time, affording no deference to the decisions of the courts below.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, National ITTS Controversy

- Lonnie Brist, *San Jose* lonnie.brist@ey.com
- Mike McDonald, *Washington, DC* michael.mcdonald4@ey.com
- Kenneth Christman, *Washington, DC* kenneth.christmanjr@ey.com
- Jose Murillo, *Washington, DC* jose.murillo@ey.com
- Stephen R Bates, *San Francisco* stephen.bates@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Transfer Pricing Group

EYG no. 003870-19Gbl

1508-1600216 NY
ED None

ey.com