DON'T SWEAT THE SMALL STUFF: THE TAX COURT TAKES A PRAGMATIC APPROACH TO TRANSFER PRICING ADJUSTMENTS FOR A CONSOLIDATED GROUP

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Tax law treats related party transactions with a certain skepticism; consequently, in the case of taxpayers who are "owned or controlled directly or indirectly by the same interests," Congress has given the IRS authority to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" them "to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." I.R.C. § 482. Although Section 482 consists of only two sentences, it has spawned several lengthy regulations and a significant body of case law in the field of transfer pricing.

The goal of the transfer pricing regime is to assure "that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." Treas. Reg. § 1.482-1(a)(1). In general, this is done by putting "a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer," *id.*, which is accomplished by applying an arm's length standard to related party transactions. Treas. Reg. § 1.482-1(b)(1).

Last week, the Tax Court addressed transfer pricing issues in the context of a consolidated return, taking a relatively pragmatic approach to some of the complexities faced by the IRS in that context. *Guidant LLC v. Comm'r*, No. 5989-11, 2016 U.S. Tax Ct. LEXIS 5 (Feb. 29, 2016). The focal point

was a provision of the transfer pricing regulations that deals with consolidated returns:

Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

Treas. Reg. § 1.482-1(f)(1)(iv).

Guidant involved audit adjustments to transactions between Guidant Corporation ("the "Parent"), its U.S. subsidiaries, and their affiliated foreign entities; the adjustments resulted in a $3.5 billion tax deficiency. 2016 U.S. Tax Ct. LEXIS 5 at *2. During the audit, the IRS determined a change to consolidated taxable income ("CTI") that attributed all of the adjustments to the Parent as part of its separate taxable income ("STI"), without initially attributing the adjustments to particular subsidiaries. *Id.*

In the taxpayer's view, the IRS should have built its case from the ground up, calculating the STI for each affiliated subsidiary included in the consolidated return; instead, the IRS simply made Section 482 adjustments to the Parent's income, even though it had not directly participated in most of the relevant transactions. *Id.* at *21-*22. In the taxpayer's view, this approach was an abuse of discretion.

The Tax Court disagreed. The court began its analysis by noting that nothing in Section 482 itself required that the IRS calculate the STI for each controlled taxpayer. *Id.* at *24. Next, it turned to Section 1.482-1(f)(1)(iv) of the Treasury Regulations, quoted above. In the Tax Court's view, the language of the regulation was critical: if the controlled taxpayer filed a separate return, then its STI "will be determined." *Id.* at *25. In contrast, the regulation did not affirmatively indicate that the STI of any controlled taxpayer covered by a consolidated return would be determined. *Id.* In the court's view, the use of different language in the regulation called for a different interpretation: "the regulation does not specifically require that the Commissioner determine STI contemporaneously with his making of a section 482 adjustment." *Id.* at *26. All the regulation requires is that both CTI and STI ultimately be determined. *Id.*

Next, the Tax Court considered whether the regulatory requirement that CTI and STI "be determined consistently with the principles of a consolidated return," Treas. Reg. § 1.482-1(f)(1)(iv), required that the IRS proceed by determining each controlled taxpayer's STI *before* calculating CTI. *Id.* In the Tax Court's view, the core principle of the consolidated return regime is to tax "the true net income of the consolidated group as a whole." *Id.* at *27 (citations omitted). In light of that principle, the court concluded that the Treasury Regulations gave "the Commissioner a certain latitude to decide when the determination of STI becomes necessary." *Id.* at *29. Consequently, the court ruled that the IRS could defer the determination of the true STI for group members "until the time when such a determination is actually required." *Id.* at *30.

The Tax Court also noted that its decision was supported by practical considerations, as an across-

the-board requirement that the IRS build a case for Section 482 adjustments from the bottom up for a consolidated group "could completely eliminate the Commissioner's ability to make Section 482 adjustments when a taxpayer consciously withholds or fails to maintain records of information necessary for STI adjustments." *Id.* at *30-*31.

As it concluded that the IRS had complied with its regulatory requirements in determining the Section 482 adjustments, the Tax Court held that there had been no abuse of discretion and denied the taxpayer's motion for partial summary judgment.

Given the limited resources of the IRS, the court's pragmatic approach to transfer pricing adjustments in the context of consolidated returns appears consistent with sound tax administration. After all, the parent of a controlled group is likely in a better position to develop evidence concerning the details of its transactions with the members of its group than the IRS. And the court's approach is consistent with the long-standing principle that the IRS can determine tax liability on the basis of estimated data in appropriate circumstances.

As for the taxpayer, while it is understandably frustrated that a $3.5 billion deficiency was calculated in a somewhat rough fashion, it remains free to prove that the IRS got it wrong.

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6

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