



International Tax ADVISORY ■

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Big Tax Court Win for Eaton in Canceled APA Case

In a significant taxpayer victory, the Tax Court, in a memorandum decision, has ruled in [*Eaton Corp. & Subsidiaries v. Commissioner*](#) that the IRS's decision to cancel Eaton Corporation's two advance pricing agreements (APAs) was an abuse of discretion. The first APA covered Eaton's 2001–2005 tax years pursuant to Rev. Proc. 96-53 (APA I), and the second covered Eaton's 2006–2010 tax years pursuant to Rev. Proc. 2004-40 (APA II). Previously, the IRS had only canceled nine APAs out of 1,597 granted to date, and a cancellation had never before been subject to public and judicial scrutiny.

At stake was more than \$126 million in deficiencies and penalties assessed by the IRS for Eaton's 2005 and 2006 tax years. For practitioners who found the protracted litigation despite the agreements troubling, the decision provides reassurance that there is a high bar for the IRS to walk away from an APA. For the IRS, the decision is the latest in a series of high-profile losses in cases involving transfer pricing.

Background

During 2005 and 2006, Eaton Corporation was the parent of a multinational group that manufactured electrical and industrial products. Eaton facilities in Puerto Rico and the Dominican Republic (the Island Plants) manufactured circuit breaker and electrical control products (breaker products), and the Island Plants licensed IP from the U.S. related to the manufacturing. The Island Plants sold their output to Eaton affiliates in the U.S., which either sold the products to third parties or incorporated them into other products, such as electrical panelboards.

Eaton applied for APA I in 2002 as part of a settlement with the IRS of an audit of its 1994–97 tax years. Both APA I and APA II were unilateral APAs (i.e., they did not involve the tax authority of a foreign country). They covered various intercompany transactions, including the sale of breaker products from the Island Plants to Eaton, Eaton's license of intangible property to the Island Plants, and the Island Plants' cost-sharing payments to Eaton.

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In early 2010, Eaton discovered multiple errors in its computations of the transfer pricing method (TPM) pursuant to the APAs and informed the IRS. To correct the errors, Eaton subsequently filed amended APA annual reports and federal income tax returns. In 2011, the IRS canceled APA I, effective January 1, 2005, and APA II, effective January 1, 2006, and proposed transfer pricing adjustments based on an application of a different TPM than was set forth in the APAs.

Prior Tax Court Ruling

In an [opinion](#) issued on June 26, 2013, the Tax Court held that an APA is not subject to ordinary contract law principles and that therefore the IRS was not required to demonstrate a breach of contract before canceling an APA. The court stated that the relevant inquiry “is whether [the IRS] abided by the self-imposed limitations set forth in the applicable revenue procedures” and that the cancellations would be reviewed under an abuse of discretion standard. To satisfy the standard, Eaton would have to show that the act of canceling the APAs was arbitrary, capricious, or without sound basis in fact. The court noted that whether the IRS had abused its discretion was a question of fact and made no determination on that issue in its opinion.

Standard of Review

The Tax Court’s 2017 opinion stated that the IRS’s arguments in support of the cancellation of the APAs fell into two categories: (1) misrepresentations, mistakes as to a material fact, and failures to state a material fact during the APA negotiations; and (2) lack of good-faith compliance in implementation of the terms of the APAs. The Tax Court emphasized that its inquiry regarding abuse of discretion was not concerned with whether the APAs’ TPMs were the best method under the Section 482 regulations.

The Tax Court stated that its analysis of the APA negotiations was focused on the APAs’ covered transactions and whether Eaton misrepresented information, as well as whether there existed a mistake as to a material fact or whether Eaton failed to state a material fact. A key issue in this analysis was whether any mistakes or omissions were “material” to the APAs’ covered transactions. Looking to the applicable revenue procedures for each APA, the Tax Court stated that for a fact to be material, “it needs to result in a significantly different APA or no APA at all.” The Tax Court also stated that the TPM is the essential part of the APA, and for a fact to be material it should have an impact on the TPM. The court defined a misrepresentation as a false and misleading statement related to the terms of the APA, usually made with the intent to deceive. The court specifically noted that a different viewpoint is not the same as a misrepresentation. The Tax Court stated in its analysis of Eaton’s APA implementation that it was focused on whether the taxpayer made a good-faith effort to comply with the terms of the APA.

The APA Negotiations

The Tax Court reviewed nine areas of the APA negotiations in terms of misrepresentations, mistakes as to a material fact, or failures to state a material fact and concluded that none of the nine areas provided sufficient grounds for cancellation. In reaching this conclusion, the Tax Court emphasized the thoroughness of the APA process and noted that the IRS could have followed up with Eaton on several of the issues it offered as grounds for cancellation but chose not to do so. The court also stated that an APA “should not be canceled because of a desire to change the underlying methodology of a method that would result in a significantly different profit split.” The crux of the Tax Court’s holding was that none of the issues it reviewed would have resulted in a significantly different APA or no APA at all.

APA Implementation

The revenue procedures governing each APA require that the taxpayer file an annual report for each APA year demonstrating compliance with the APA's terms and conditions. After reviewing seven of Eaton's errors in its annual reports, both individually and in the aggregate, the court stated that all seven of Eaton's errors were computational or related to inadvertence and were corrected in the amended APA annual reports, and concluded that Eaton had made good-faith efforts to comply with the terms of the APAs.

As for materiality, the Tax Court chose not to adopt a bright-line rule and instead looked to the size of the error, the nature of the error, how it occurred, and Eaton's actions once the error was discovered. Viewed that way, the court stated that the errors were inadvertent, not deliberate, and would not have resulted in a significantly or materially different APA, thus not meriting cancellation of the APAs. In sum, the Tax Court held that the cancellation of the APAs by the IRS was arbitrary and unreasonable under the applicable abuse of discretion standard and should not be sustained.

Where to from Here?

The initial decision by the IRS to cancel Eaton's APAs raised concerns about whether the time-consuming and expensive process of obtaining an APA was a worthwhile use of resources if the APA did not, in fact, provide certainty for the covered transactions. The Tax Court's taxpayer-favorable decision should go a long way to allay those concerns.

Because the Tax Court's decision was a factual decision under the abuse of discretion standard, in order to overturn the decision on appeal the IRS would have to demonstrate that the Tax Court's findings of fact were clearly erroneous. Once the Tax Court's decision is finalized, the IRS will have 90 days to determine whether it will file an appeal.

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