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International Tax Watch

Eaton on Appeal: Advanced Pricing Agreements Are Contracts

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The Sixth Circuit recently gave Eaton Corporation ("Eaton") a victory in *Eaton Corporation v. Commissioner*.[1] We previously wrote about Eaton's 2017 Tax Court victory, where the Court held that the Internal Revenue Service ("IRS") abused its discretion in canceling Eaton's advanced pricing agreements ("APAs") for its 2005 and 2006 tax years.[2] The Tax Court opinion was excellent news for taxpayers that use, or wish to use, APAs to obtain transfer pricing certainty because the court limited the IRS' ability to cancel APAs. The Sixth Circuit's recent opinion takes the Tax Court's fundamental holding even further. Following the extensive proceedings in the Tax Court (collectively, "*Eaton I*"), the Tax Court held that the IRS' decision to terminate an APA is subject to review for abuse of discretion, and consistent with administrative law principles, the burden of proving that abuse of discretion was on the taxpayer.[3] In the Sixth Circuit's opinion ("*Eaton II*"), the Sixth Circuit leveled the playing field. The Sixth Circuit concluded that an APA is a contract and its interpretation is a matter of contract law. Though *Eaton II* held in favor of the taxpayer on different grounds than *Eaton I*, the Tax Court's decisions and the Sixth Circuit's recent opinion share the same basic thrust. Both decisions gave taxpayers more certainty and control over APAs. Given that certainty is the whole point of an APA, these decisions should give taxpayers the comfort that when they conclude an APA, they will receive the certainty that they bargained for.

First, we walk through background on Eaton. Second, we briefly cover the Tax Court proceedings in *Eaton I*. Third, we analyze the Sixth Circuit's opinion in *Eaton II*. We close with some observations about the long-ranging effects of *Eaton II*.

I. Eaton and Its APAs

Eaton is an Ohio corporation that had foreign subsidiaries in Puerto Rico and the Dominican Republic (the "Island Plants") during 2005 and 2006. Eaton and its subsidiaries manufactured electrical products, including "Breaker Products," which are electrical safety products. The Island Plants manufactured most of Eaton's Breaker Products.

In 2002, Eaton had a pre-filing conference with the IRS to discuss the possibility of making a request for an APA. After a multi-year negotiation, Eaton and the IRS entered into an APA ("APA-I") that covered three related-party transactions for Eaton's 2001–2005 tax years. Eaton renewed the APA with respect to one of those related-party transactions for its 2006–2010 tax years ("APA-II"). APA-I incorporated the text of Rev. Proc. 96-53, and APA-II incorporated Rev. Proc. 2004-40, which were the Revenue Procedures that purported to govern the interpretation, legal effect, and administration of APAs.

The most important lesson to be learned from Eaton II is that an APA is a contract. Because it is a contract, the parties to the agreement have control over its substantive terms and performance under it.

The two APAs specified a transfer pricing methodology under which Eaton calculates the transfer price according to two steps.[4] First, the APAs used the comparable uncontrolled price ("CUP") method to calculate the hypothetical profits. Second, Eaton would test out the profits it came up with using the CUP method against the hypothetical profits derived by applying the comparable profits method ("CPM") in the manner they had agreed upon. If the CPM yielded a "Berry ratio," *i.e.*, the ratio of gross profits to operating expenses, outside of the range the APAs allowed, then Eaton would have to reduce the transfer price it paid to the Island Plants. The APAs required Eaton to file annual reports to demonstrate that it was complying with the agreements and to notify the IRS of any changes to critical assumptions or material facts.

In 2007, the IRS started an exam of Eaton's 2005 and 2006 tax returns, which ended up including a review of how Eaton implemented the APAs. In 2009, Eaton started its own internal review. As part of that internal review, Eaton discovered that it had made some miscalculations. Eaton made some mistakes in applying the "APA Multiplier."[5] The APA Multiplier translated the transfer-pricing-methodology-calculated prices into numbers that aligned with Eaton's bookkeeping. The APA Multiplier accounted for the fact that the transfer pricing methodology from the APAs uses "accounting language" that differed from Eaton's internal records. The APA Multiplier was not part of the transfer pricing methodology. Rather, it allowed the transfer pricing methodology to accurately reflect Eaton's books. Eaton did not use the APA Multiplier to complete the annual reports it provided to the IRS pursuant to the APAs. Eaton used the APA Multiplier to develop the final numbers that were reflected on its tax returns. As part of its internal review, Eaton determined that it had used the wrong denominator in calculating the APA Multiplier. Eaton further concluded that miscalculation resulted in Eaton reporting an inflated transfer price on its returns. Because its annual transfer pricing report did not go through the APA Multiplier process, those reports contained accurate transfer pricing numbers.[6] Eaton's returns reported different numbers from its annual transfer pricing reports.

In 2010, Eaton informed the IRS of its mistakes, corrected the errors, and submitted amended tax returns. In 2011, the IRS canceled the APAs for 2005 and 2006 on the grounds that "several 'material deficiencies in APA compliance' warranted cancelation, including 'mistake as to a material fact,' 'failure to state a material fact,' and 'errors in the supporting data and computations used in the transfer pricing methodologies.'"[7] In 2011, the IRS sent Eaton a notice of deficiency ("NOD") reflecting the IRS' determination that Eaton owed $19,714,770 for 2005 and $55,323,229 for 2006. The IRS also sought to impose 40% gross valuation misstatement penalties under Code Sec. 6662(h) for both years. Eaton timely petitioned the Tax Court to challenge the deficiency and the penalties.

II. *Eaton I*—The Case in the Tax Court

During the decade-long proceeding, the Tax Court held the following, as relevant to the Sixth Circuit appeal:

1. The Tax Court's deficiency jurisdiction included reviewing the IRS' decision to cancel the APAs because the review was necessary to determine the merits of the deficiencies.
2. Whether the IRS' decision to cancel was valid is based on whether the IRS abused its discretion in canceling the APAs.
3. Eaton, and not the IRS, had the burden of proving that the IRS abused its discretion.

4. The IRS did indeed abuse its discretion in canceling the APAs because Eaton's errors did not meet the "material" standard that allowed cancelation under the Revenue Procedures that controlled the APAs.
5. Eaton was not liable for the 40% penalty under Code Sec. 6662(h) for its self-reported corrections because the self-corrections did not constitute a Code Sec. 482 adjustment.
6. Because Eaton's self-corrections did not constitute Code Sec. 482 adjustments, Eaton was not eligible for relief from double taxation under Rev. Proc. 99-32.

The IRS appealed the Tax Court's holdings with respect to the APA cancelation and penalties. Eaton cross-appealed with respect to Rev. Proc. 99-32 relief.

III. *Eaton II*—The Case Before the Sixth Circuit

On August 25, 2022, the Sixth Circuit held for the taxpayer, albeit on different grounds than the Tax Court below. The Sixth Circuit addressed four issues: (1) Who bears the burden of proof to show that the IRS' decision to cancel the APAs was wrongful? (2) Was the IRS' decision to cancel the APAs wrongful? (3) Was the IRS' assertion of Code Sec. 6662(h) penalties during Rule 155 proceedings valid? And (4) was Eaton entitled to relief under Rev. Proc. 99-32? Judge John Nalbandian wrote the opinion.

A. Canceling the APAs—Who Bears the Burden of Proof, and Was It Satisfied?

The Sixth Circuit began its analysis by asking who bears the burden of showing whether the IRS' decision to cancel the APA was wrongful. Though the court framed the question as a burden of proof issue, it analyzed it as more of a choice of law question. Judge Nalbandian first addressed whether the question of wrongful cancelation was a matter of administrative law or contract law. If administrative law governed the decision, then the burden would be on Eaton to show that the decision to cancel the APAs was arbitrary. By contrast, if the APAs were contracts, then consistent with contract law, the burden of proof would be on the IRS as the party seeking to void the binding agreement.

The Sixth Circuit held that the APAs are contracts. Judge Nalbandian looked to the applicable Revenue Procedures, Rev. Proc. 2004-40 and Rev. Proc. 96-53, which state that an "APA is a binding agreement between the taxpayer and the Service."[8] He noted that the IRS often enters into contracts with taxpayers, such as closing agreements and offers-in-compromise.[9] Case law shows that when the U.S. government (which includes the IRS) enters into a contract, the law that applies to contracts between private parties generally controls the IRS' rights and responsibilities.[10] Consistent with "contract law," the court held that the party that seeks to "back out of contractual promises" must prove the "exception" that allows it to do so.[11] Before ultimately concluding that the APAs are contracts, Judge Nalbandian dispensed with the IRS' argument that the APAs' own terms provide that they are controlled by the relevant Revenue Procedures.

The fact that APAs are contracts makes it much easier for both the IRS and taxpayers to determine how courts will interpret them. Both parties can draw straight from the vast body of contract law when they evaluate how a particular term will be interpreted.

Although acknowledging that the Revenue Procedures say that the IRS "may" cancel the APA if one of the specific conditions occurs, Judge Nalbandian cautioned that the IRS' discretion under the APAs allows it to cancel the APA "when a condition is satisfied," but its discretion does not allow the IRS to "conclusively determine that a condition is satisfied."[12] The court wrote that if Eaton and the IRS meant for the IRS to have that sort of power with respect to the APAs, the parties could have specified that in the contracts, "[b]ut they *didn't*."[13] Though the parties explicitly agreed that "Rev. Proc. 96-53 governs the interpretation, legal effect, and administration of" APA-I, and "Rev. Proc. 2004-40 governs" as to APA-II, the Revenue Procedures say nothing about the burden of proof.[14] Similarly, the parties did not address the burden of proof in the APAs. The court concluded that the APAs are contracts, and "consistent with contract-law principles," the IRS bears the burden of proving that the agreed upon grounds for canceling the APA had occurred.[15]

After concluding that "contract law"[16] controlled the interpretation of the APAs, Judge Nalbandian analyzed whether, pursuant to the terms of the APAs, the IRS had properly canceled the contracts. As noted above, the APAs integrated the Revenue Procedures' terms into their own text.

The Revenue Procedures contained two subsections that were in dispute. The first subsection was titled "Cancelling the APA," and it listed the following reasons for which the IRS "may cancel" the APA: "'the failure of a critical assumption,' 'the taxpayer's 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 APA.'"[17] The second subsection was titled "Examination" and contained items that the IRS "may require the taxpayer to establish" in enforcing APAs.[18] Specifically, the "Examination" subsection set forth the following conditions: "good faith compliance with the APA, materially accurate APA reports, consistent application of the TPM, and continued satisfaction of the 'critical assumptions.'"[19] The IRS argued that if the taxpayer failed to satisfy any of the conditions in the "Examination" subsection, the IRS would have the power to enforce, revise, cancel, or revoke the APA. Over the IRS' objections, the court held that the items in the "Examination" subsection provided conditions that would allow the IRS to cancel the APA only to the extent they overlapped with the conditions in the "Cancelling the APA" subsection.[20] That meant that errors in the supporting data and computations used in applying the transfer pricing method did not, on their own, permit the IRS to cancel the APA.[21]

That left only one ground for canceling the APA that the IRS argued on appeal: whether Eaton's errors and alleged omissions constituted a failure to state material facts or mistakes as to material facts. The court's analysis focused on whether Eaton's actions were "material." To be material, the alleged omissions had to constitute omissions of facts or failures to state facts "that, if known by the Service, would have resulted in a significantly different APA (or no APA at all)."[22]

The court first dispensed with the IRS' first argument that Eaton allegedly failed to disclose the APA Multiplier with respect to APA-I. Eaton disclosed how the multiplier was computed and applied in an information document request the IRS issued, and at least one member of the IRS Exam team that issued that information document request participated in the negotiations for APA-II. The court held these facts showed that the IRS knew about the APA Multiplier and this knowledge did not result in a significantly different APA because APA-II was for all intents and purposes identical to APA-I.[23]

The court then dispensed with the IRS' second and third arguments—that Eaton's inadvertent miscalculation of the APA Multiplier and the resulting mistakes in the annual reports provided grounds for cancelation. The court held that the question of materiality had to do with the facts existing at the time of the contract formation.[24] That Eaton would unintentionally make future math mistakes after the government and Eaton entered into the APA could not have affected the IRS' decision to enter into the agreement and were not, therefore, material.[25] Because the annual report errors resulted from the miscalculation of the APA Multiplier, that error was not material.[26] Ultimately, the court concluded that the IRS was never entitled to cancel the APAs.

B. The Code Sec. 6662 Penalties

In Tax Court Rule 155 proceedings, the IRS argued that Eaton was liable for 40% penalties under Code Sec. 6662(h). Code Sec. 6662(h) provides a penalty for the portion of the underpayment attributable to a gross valuation misstatement.[27] In the NOD issued in 2011, the IRS asserted that the Code Sec. 6662(h) penalty was based on its own calculation, applying the cost-plus method and testing the Island Plants' profits against the profits of comparable companies. The IRS used this approach and did not test Eaton's profits, because the IRS assumed it had validly canceled the APAs.[28] That approach resulted in a determination of an underpayment to which the gross valuation misstatement penalty applied. After the Tax Court held that the IRS had abused its discretion in canceling the APAs, in the Rule 155 proceedings, the IRS changed its position. The IRS based the penalty on Eaton's self-correction of its APA Multiplier miscalculation. The two bases for imposing the penalty (the pre-trial position set forth in the NOD and the post-trial position the IRS adopted after the court concluded the IRS abused its discretion) were entirely different.

Eaton responded with three arguments: (1) the IRS forfeited this new argument by failing to raise it before trial, (2) Eaton's self-corrections could not trigger penalties because they did not constitute Code Sec. 482 adjustments, and (3) the IRS failed to obtain Code Sec. 6751(b) approval for the penalty. The Court addressed arguments one and two and did not need to deal with the argument three. First, because APAs are an extension of the IRS' allocation authority under Code Sec. 482, Eaton's self-corrections made pursuant to the APA were Code Sec. 482 adjustments.[29] Second, the court held that the IRS' post-trial basis for asserting the penalty was fundamentally different from its pre-trial basis and that the IRS failed to plead or even raise the alternative basis of penalties during or before the trial. The court held that the IRS waived its right to base penalties on the alternative grounds because it failed to plead or address the issue at trial.[30] The court held that the IRS waived or forfeited its claim to penalties under Code Sec. 6662(h) based on its own calculation, where it assumed the APAs were invalid.

C. Relief from Double Taxation

Eaton's self-corrections resulted in additional U.S. income and income tax liability, but Eaton's non-U.S. subsidiaries retained that cash. Once the non-U.S. subsidiaries repatriated the cash to the United States, that increased Eaton's income tax liability, all of which subjected Eaton to being taxed twice on the same income. Rev. Proc. 99-32 provides relief for taxpayers in Eaton's position. Rev. Proc. 99-32 treats the original overpayment as a loan or advance. As a result, when the taxpayer repatriates the cash, the IRS treats the taxpayer as repaying a loan, even if from a non-tax perspective, the taxpayer uses a dividend to repatriate the cash. Receiving principal payments on a loan does not, in and of its self, give rise to income. Rev. Proc. 99-32 applies to Code Sec. 482 adjustments. Given the court had already concluded the increases to income that resulted from Eaton's self-corrections were Code Sec. 482 adjustments, and because the parties agreed Rev. Proc. 99-32 applied to Code Sec. 482 adjustments, the court granted Eaton relief from double taxation arising from its self-corrections.

IV. The Implications of *Eaton II*

The most important lesson to be learned from *Eaton II* is that an APA is a contract. Because it is a contract, the parties to the agreement have control over its substantive terms and performance under it. We believe that *Eaton II*'s holding that APAs are contracts gives taxpayers more certainty and control. Contracts are agreements that the two parties negotiate. The parties to an agreement have the power to negotiate the agreement's terms and ultimately to decide whether or not to agree to terms with each other. A contract creates some amount of parity between the parties, and contract law takes that into account. Administrative law, by contrast, usually presumes that the agency's action was lawful. Administrative law tilts the playing field in favor of the IRS through the standard of review, scope of review, administrative exhaustion, and similar structures that can make it very difficult for the taxpayer to challenge the IRS' administrative action. In a contract dispute, neither party is presumed correct. In *Eaton II*, Eaton won because it complied with the terms of the agreement, and the IRS did not.

The IRS may often have the upper hand in APA negotiations because it is the taxpayer who is applying for, and presumably eager to conclude, the APA. In practice, once a taxpayer applies for an APA and commits the time and expense, it has a strong incentive to reach an agreement. The fact that the taxpayer shares a significant amount of information with the IRS that the IRS might not otherwise have puts further pressure on the taxpayer to make concessions so that the parties will ultimately reach an agreement. The IRS, on the other hand, simply is not under the same level of pressure to reach an agreement.

The fact that APAs are contracts makes it much easier for both the IRS and taxpayers to determine how courts will interpret them. Both parties can draw straight from the vast body of contract law when they evaluate how a particular term will be interpreted. That breadth of authority allows taxpayers to predict, with a higher degree of certainty, how the courts will interpret any given term if there is ever a dispute between the parties over the APA's meaning. Treating the IRS' attempt to walk away from an APA as a contract dispute, as opposed to an administrative law dispute, also provides more certainty for taxpayers because administrative law provides so much discretion to the IRS and other administrative agencies.[31] For example, for a taxpayer to prevail in abuse-of-discretion review, the taxpayer must show that the IRS' action was "arbitrary, capricious, or without sound basis in fact."[32] Under that standard, if the IRS made a decision that was anything less than egregious, the taxpayer should lose. Similarly, under ordinary circumstances, administrative law confines a court's review of the agency action to only those materials that are in the administrative record.[33] Though there are exceptions to the so-called record rule, it requires taxpayers to dispute only the facts addressed at the agency level, which can have the effect of waiving viable arguments that could otherwise be made in court.[34] These rules, as well as many other administrative law principles, stack the deck in favor of the government.

Given the time, energy, and expense that taxpayers devote to concluding an APA, not to mention the substantive concessions on the underlying transfer pricing terms, allowing the IRS to walk away from an APA under an abuse-of-discretion standard is inappropriate and could chill taxpayers' interest in obtaining APAs. Moreover, as noted above, the parties negotiate and agree upon the terms of an APA, which is exactly what contracting parties do. Substantively, an APA is undeniably an agreement and it should be treated as a contract.

The Sixth Circuit gave Eaton a significant win and multinationals a huge opportunity to negotiate APAs with some reassurance about how courts would decide issues in the event of a dispute. That predictability is what APAs, and contracts more generally, were designed to provide. And though we have yet to learn how *Eaton II* affects the IRS' appetite for entering into APAs, we believe that the certainty and control *Eaton II* provides may make the long and expensive APA process more appealing to multinational taxpayers.

ENDNOTES

1 *Eaton Corporation*, Nos. 21-1569 and 21-2674 (Aug. 25, 2022), *aff'g on other grounds Eaton*, 114 TCM 90, Dec. 60,976(M), TC Memo. 2017-147.

2 Stewart R. Lipeles, Joseph A. Myszka, and Ethan S. Kroll, *Tax Court Holds IRS Abused Its Discretion in Cancelling APAs*, TAXES at 5 (January 2018).

3 *Eaton Corp.*, 140 TC 410, Dec. 59,575 (2013); *Eaton Corp.*, 114 TCM 90, Dec. 60,976(M), TC Memo. 2017-147; *Eaton Corp. & Subsidiaries*, 153 TC 119, Dec. 61,567, 153 TC No. 6 (2019).

4 Both steps require the use of transfer pricing methods laid out in the Treasury Regulations. The comparable uncontrolled price ("CUP") method is in Reg. §1.482-3. The CUP method requires taxpayers to identify similar goods for sale with comparable uncontrolled taxpayers, and determine the transfer price according to comparable transactions involving those goods. The comparable profits method ("CPM") is laid out in Reg. §1.482-5. The CPM method requires taxpayers to compare their operating results with those of uncontrolled taxpayers.

5 Eaton also discovered it made some errors in applying the transfer pricing method, which affected the computation of the transfer price, but that was not at issue in *Eaton II*.

6 The annual reports contained some misrepresentation, including "that Eaton's tax returns listed the correct numbers." *Eaton II*, slip op. at 6.

7 *Eaton II*, slip op. at 6 (quoting letter from IRS).

8 *Eaton II*, slip op. at 8. Judge Nalbandian also noted that the APAs refer to themselves as contracts.

9 *Eaton II*, slip op. at 8 and 9.

10 *Eaton II*, slip op. at 9.

11 *Id.*

12 *Eaton II*, slip op. at 10 and 11.

13 *Eaton II*, slip op. at 11.

14 *Id.*

15 *Eaton II*, slip op. at 12.

16 The court never spelled out whose contract law applies, but we presume it applied the federal common law of the Sixth Circuit.

17 *Eaton II*, slip op. at 12 (quoting Rev. Proc. 2004-40, §10.06(1), IRB 2004-29, 50; 2004-2 CB 50).

18 *Eaton II*, slip op. at 13 (quoting Rev. Proc. 2004-40, §10.03(2), IRB 2004-29, 50; 2004-2 CB 50; Rev. Proc. 96-53, §11.03(2), IRB 1996-49, 9; 1996-2 CB 375).

19 *Eaton II*, slip op. at 13 (quoting Rev. Proc. 2004-40, §10.03(2), IRB 2004-29, 50; 2004-2 CB 50; Rev. Proc. 96-53, §11.03(2), IRB 1996-49, 9; 1996-2 CB 375).

20 *Eaton II*, slip op. at 13.

21 *Eaton II*, slip op. at 15.

22 *Id.* (quoting Rev. Proc. 96-53, §11.06(1), IRB 1996-49, 9; 1996-2 CB 375).

23 The IRS also raised Eaton's failure to include the APA Multiplier in its formal application for APA-II, but the Court called that argument a "red herring" as the inquiry was whether the IRS knew about the APA Multiplier, which it did. *Eaton II*, slip op. at 16 and 17.

24 *Eaton II*, slip. op. at 17.

25 *Id.*

26 *Eaton II*, slip op. at 18. The Court noted that the IRS' rights under the APAs with respect to the errors in the annual reports were enforcement rights, not cancelation rights. *Id.*

27 The Code Sec. 6662(h) penalty can be imposed when the net Code Sec. 482 transfer price adjustment exceeds the lesser of $20 million or 20% of the taxpayer's gross receipts.

28 *Eaton II*, slip op. at 19.

29 *Eaton II*, slip op. at 20.

30 *Eaton II*, slip op. at 22.

31 *See* Sydney A. Shapiro & Richard E. Levy, *Judicial Incentives and Indeterminacy in Substantive review of Administrative Decisions*, 44 DUKE L. J. 1051, 1052 (1995).

32 *Eaton Corp.*, 114 TCM 90, Dec. 60,976(M), TC Memo. 2017-147; *see also* Administrative Procedure Act, 5 USC sec. 706(2)(A).

33 *See* Administrative Procedure Act, 5 USC sec. 706(2)(E). Admittedly in *Eaton Corp.*, 114 TCM 90, Dec. 60,976(M), TC Memo. 2017-147, the Tax Court did not restrict itself to the administrative record, as it conducted a trial *de novo*.

34 Administrative exhaustion, a standard precept of administrative law, can also have a preclusive effect like the record rule.