

# WNTS Insight

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## *Claims Court: Transfer pricing regulations bar amended return that would reduce taxable income*

Citing the "plain meaning" of one provision of the section 482 transfer pricing regulations, the U.S. Court of Federal Claims has held that the regulations prohibit a taxpayer from making any changes to the computation of transfer prices on an amended return if those changes would reduce the taxpayer's taxable income. The taxpayer, Intersport Fashions West (Intersport), has appealed the decision to the U.S. Court of Appeals for the Federal Circuit.

### *Background*

Intersport is a U.S. corporation that designs and distributes motorcycle clothing in the United States. Intersport was acquired in 1999 by a German corporation (Eurobike). In 2001, 2002, and 2003, Intersport paid Eurobike various "fees" and "charges" that it deducted on its tax returns for those years. In 2005 the IRS audited Intersport for the 2001-2003 tax years.

Following the audit, Intersport filed amended returns for 2001 and 2002 in which it included claimed deductions based on allocations relating to those tax years of restructuring expenses incurred by Eurobike. The amended returns were filed after the due date (including extensions) for those years. The IRS denied the deductions claimed on the amended returns for 2001 and 2002, citing Reg. sec. 1.482-1(a)(3), which provides, in part, that "a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged....No untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions."



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The IRS allowed the deductions claimed by Intersport for 2003, which also were based on allocations of Eurobike's restructuring expenses but were claimed on Intersport's timely filed, original 2003 return, and therefore allowable under Reg. sec. 1.482-1(a)(3).

Intersport filed a refund claim with the Court of Federal Claims in 2007. The court in 2008 dismissed Intersport's claim for 2001 on procedural grounds, leaving only the claim for 2002 at issue. In 2009 the government filed a motion for summary judgment on Intersport's 2002 refund claim. The court then stayed the case, pending Intersport's bankruptcy proceedings. Those proceedings ended in 2011, after which the Claims Court lifted the stay on Intersport's refund claim.

## Claims Court decision

The issue facing the court in addressing the government's motion for summary judgment was "whether [Intersport] may report deductions from a controlled transaction that would decrease [its] taxable income on an amended return filed after the due date, including extensions, of the original return."

The court began its application of Reg. sec. 1.482-1(a)(3) to the facts of the case by noting that "the plain meaning of the Treasury Regulations is controlling." Citing the U.S. Supreme Court's 1941 decision in *Scaife Co. v. Commissioner* -- that an amended return filed after the due date for the original return is untimely -- the Claims Court concluded that Intersport's 2002 amended return was similarly untimely, and that because Intersport had attempted to use that untimely, amended return to claim additional deductions that would decrease its taxable income, those claims are barred by Reg. sec. 1.482-1(a)(3).

The Claims Court then turned to Intersport's contention that its original filing for 2002 was a "mistake." Again citing *Scaife*, and its companion case (*Lerner*), the court concluded that even a mistake in computation may not be corrected on an amended or untimely return when the regulations expressly prohibit the filing of such a return if the return would reduce taxable income. **Note:** The government did not concede that the taxpayer had made a mistake in its original claimed deductions.

Next, the court addressed Intersport's contention that its deductions should be allowed under the doctrine of substantial compliance because it "substantially complied with the regulation" and the regulation is procedural, not substantive. In rejecting this contention, the court cited the decision of the Federal Circuit (the court to which Claims Court decisions are appealable and, as noted above, to which Intersport already has appealed) in *Credit Life*. That decision construed the doctrine of substantial compliance narrowly by requiring a showing of a good excuse for noncompliance and that the regulation was unimportant, unclear, or confusing. Because Intersport failed to point to evidence in the record to meet these requirements, the Claims Court concluded that it could not use the doctrine of substantial compliance to overcome the plain language of the regulations.

Finally, the court rejected Intersport's contention that allowing the deductions on the return for 2003 but disallowing the deductions for 2001 and 2002 was inconsistent with the purpose of section 482, which is stated in the regulations to be "to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." First, the court stated, deductions allowed in one tax year do not require the same treatment in other tax years. Second, the regulations at issue were properly promulgated under authority delegated to the IRS in section 482 itself. "The court cannot say that the Commissioner's actions, following properly promulgated regulations designed to implement section 482, violate the statute."

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Having addressed Intersport's arguments, the court granted summary judgment to the government.

### *Final observations*

The Claims Court conclusion in *Intersport* reflects what the court called the "plain meaning" of the regulations, namely, that taxpayers may not reduce their taxable income once their return is filed as a result of improper transfer pricing.

Whether a taxpayer may correct on an amended return a simple mistake in execution of an already chosen best method is a question that should continue to be considered. If the Claims Court decision is affirmed on appeal, taxpayers should prepare for the possibility that efforts to correct a simple mistake or calculation error may be challenged by the IRS.

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