Ninth Circuit affirms Amazon and accepts taxpayer's position on the definition of intangible property

August 28, 2019

In brief

The U.S. Court of Appeals for the Ninth Circuit on August 16, 2019, affirmed the U.S. Tax Court's decision in *Amazon.com, Inc. v. Commissioner*, concerning the definition of intangible property in the transfer pricing regulations, as applied to determine the compensable value of a cost sharing buy-in.

Many taxpayers and the Internal Revenue Service (IRS) had long disagreed over whether the definition of 'intangibles' in the transfer pricing regulations under Section 482, and the nearly identical statutory definition applied for purposes of Section 367(d) (providing for periodic income inclusions with respect to certain outbound transfers of intangibles), encompassed goodwill, going concern value, workforce-in-place, and similar elements that are not discrete items of intellectual property. The scope of the section 482 definition was relevant to the valuation of the cost sharing buy-in at issue in the *Amazon.com* case because the applicable cost sharing regulations (those in place prior to the amendment of the cost sharing regulations in 2009) required that a buy-in payment provide arm's length compensation for the transferor's 'pre-existing intangibles.' The IRS had valued Amazon's buy-in using an income method that swept in 'residual-business assets,' including elements such as goodwill, going concern value, the value of workforce-in-place, 'growth options,' and value stemming from Amazon's culture of innovation, which the IRS argued were intangibles under the relevant definition.

After parsing the text of the regulations, considering the overall regulatory scheme, and reviewing the administrative history of the regulatory definition as it had evolved over many years, the Ninth Circuit held that the definition of intangibles included only assets that were independently transferable, and did not encompass residual-business assets. Furthermore, the court held that the Tax Court was not required to give deference to the IRS's interpretation of its regulation (so-called '*Auer* deference'), because the administrative history left little room for the IRS's proffered interpretation and because of the unfair surprise that would be created by crediting an agency interpretation first announced as a litigating position in the case. Consequently, the Ninth Circuit upheld the Tax Court decision, which had rejected the IRS's valuation approach specifically because the court found it to include many items of value that were not intangibles under the applicable cost sharing regulations.

The Ninth Circuit opinion is relevant to the valuation of cost sharing buy-ins under the regulations in place prior to 2009. The cost sharing regulations were amended in 2009, however, to expand the scope

of contributions to a cost sharing arrangement that require compensation to include all 'resources, capabilities and rights' reasonably anticipated to contribute to the development of the cost shared intangibles.

The Ninth Circuit opinion is also relevant in interpreting the statutory definition of intangible property in place prior to its amendment in the 2017 tax reform act. That statutory definition, provided in former Section 936(h)(3)(B), was almost identical to the regulatory definition at issue in *Amazon.com*, and its legislative history was specifically considered by the Ninth Circuit in reaching its conclusion. That statutory definition governed which intangibles were subject to the commensurate-with-income standard under the second sentence of Section 482, and which intangibles triggered income inclusions under Section 367(d). As a result of the 2017 Act, however, the statutory definition of intangible property for these purposes (currently Section 367(d)(4)) now explicitly includes goodwill, going concern value, workforce-in-place, and any other item that has value not attributable to tangible property or the services of an individual.

Finally, with respect to the interpretation and application of tax regulations more generally, the Ninth Circuit opinion provides an indication of the circumstances under which a court may or may not give deference to an IRS interpretation of a regulatory provision.

In detail

Factual and procedural background

In 2005, Amazon.com, Inc. (Amazon US) entered into a cost sharing arrangement with its European subsidiary. In conjunction with that arrangement, Amazon US granted the subsidiary the right to use certain pre-existing intangibles in a cost sharing buy-in transaction. In the Tax Court proceeding, Amazon and the IRS offered fundamentally different approaches for valuing Amazon's pre-existing intangibles under Section 482. Amazon isolated and valued only the specific intangible assets that it transferred to the European subsidiary under the cost sharing arrangement, including website technology, trademarks, and customer lists. The IRS's proposed method, in contrast, essentially valued the entire European business. That method necessarily swept into the calculation all contributions of value, including those that are more nebulous and inseparable from the business itself, such as the going concern value, goodwill, and other unique business attributes and expectancies attached to the business (residual-business assets).

In 2017, the Tax Court issued an opinion that rejected the IRS's valuation approach, reasoning that residual-business assets were not within the applicable definition of intangibles under the pre-2009 cost sharing regulations (as discussed below). For more information on the factual background of the case and the Tax Court opinion, see PwC's Tax Insight on the Tax Court decision.

The applicability of the regulations in question

On appeal, the Ninth Circuit considered whether, under the pre-2009 cost sharing regulations, the buy-in required for 'preexisting intangible property' must include compensation for residual-business assets.

In dicta, the court noted:

> This case is governed by regulations promulgated in 1994 and 1995. In 2009, more than three years after the tax years at issue here, the Department of Treasury issued temporary regulations broadening the scope of contributions for which compensation must be made as part of the buy-in payment . . . In 2017, Congress amended the definition of 'intangible property' in 26 U.S.C. § 936(h)(3)(B) (which is incorporated by reference in 26 U.S.C. § 482) . . . If this case were governed by the 2009 regulations or by the 2017 statutory amendment, there is no doubt the Commissioner's position would be correct.

Observation: Notwithstanding the court's dicta, the court's interpretation of the intangibles definition applies to buy-in transactions occurring before the effective date of the 2009 cost sharing regulations. For these transactions, under the Ninth Circuit's holding, the buy-in payments for 'pre-existing intangibles' need not cover the value goodwill, going concern value, workforce-in-place, or other similar items that do not represent separately transferable items of intangible property.

The text of Treas. Reg. sec. 1.482-4(b)

The Ninth Circuit began its analysis by evaluating the text of the applicable regulatory definition. Treas. Reg. sec. 1.482-4(b) defines an 'intangible' as an asset that both "has substantial value independent of the services of any individual" and is one of the items listed in subsections (b)(1) through (b)(6). Treas. Reg. sec. 1.482-4(b)(1) through (b)(5) include familiar intangibles such as patents, inventions, formulae, processes, designs, copyrights, trademarks, methods, programs, and procedures, while Treas. Reg. sec. 1.482-4(b)(6) is

a catchall provision covering 'other similar items.'

Amazon argued that residual-business assets are not 'similar items' because, unlike the items explicitly listed, they cannot be bought or sold independently of the business. Amazon also argued that attributes such as a workforce do not have any value independent of the services of individuals.

The IRS countered that residual-business assets are covered under the plain meaning of the text because the regulatory catchall provision stated that an item is considered similar as long as "it derives its value . . . from its intellectual content or other intangible properties."

The court concluded that analysis of the regulatory text, by itself, did not definitively answer the question. The court found that Amazon's concerns about stretching the catch-all provision too far were legitimate, observing that it was not self-evident whether amorphous residual-business assets such as growth options or innovative culture have "substantial value independent of the services of any individual." The Ninth Circuit nonetheless acknowledged that the definition could be construed as covering residual-business assets if the language were viewed in isolation.

Overall regulatory scheme favors Amazon

The Ninth Circuit then proceeded to analyze the overall transfer pricing regulatory framework, stating that the court was required to look at the regulatory scheme as a whole. The court considered the IRS argument that the regulatory purpose of the Section 482 regulations as a whole requires that compensation be paid for "*anything* of value that is made available between related parties" in the buy-in transaction, regardless of whether it is defined as an intangible.

As support, the IRS cited the Ninth Circuit's previous opinion in *Xilinx, Inc. v. Commissioner* for the proposition that the paramount purpose of the Section 482 regulations is to ensure that related parties report arm's length results. The IRS argued that this standard supported its position because an unrelated party would have clearly required compensation for its residual-business assets. The Ninth Circuit did not accept this IRS argument, however, because it was not clear to the court why Amazon's transfer of intangibles under its cost sharing agreement should be treated as a sale of the business.

Observation: In a footnote, the Ninth Circuit also cautioned against overreliance on the primary opinion in *Xilinx*, noting that the concurring judge (who provided the majority vote for the disposition of that case) wrote a separate concurring opinion that did not seem to adopt the '[p]urpose is paramount' logic.

The court found that the regulatory scheme as a whole tended to favor Amazon's position more than the IRS position. The court observed that the cost sharing regulations describe intangibles as being the product of research and development efforts. From this, the court reasoned that "the regulations seem to contemplate a meaning of 'intangible' that excludes items like goodwill and going concern value, which 'are generated by earning income, not by incurring deductions.'"

Observation: As support for its observation that items such as goodwill and going concern value are not generated by incurring deductions, the court cited to a Joint Committee on Taxation explanation of the 1984 legislation that enacted the Section 367(d) regime. The Joint Committee explanation had offered this distinction as the rationale for the related legislative history expressing an intent that outbound transfers of goodwill and going concern value should not be subject to tax.

Drafting history of regulations supports Amazon

The court next turned to an analysis of the drafting history of the regulatory definition of intangibles. It was the court's detailed review of the historical development of the intangibles definition that appeared ultimately to lead the court to hold for Amazon.

The regulatory definition of intangibles first appeared in the transfer pricing regulations issued in 1968. Congress enacted a nearly identical statutory definition of 'intangible property' in 1982, which was incorporated by reference into the commensurate-with-income provision of Section 482 enacted in 1986.

Two years later, the IRS issued the Congressionally mandated study of transfer pricing known as the 'White Paper.' The White Paper discussed (among other things) cost sharing arrangements, and proposed that the intangibles subject to the cost sharing buy-in requirement include the going concern value associated with a party's research facilities. After receiving opposing comments, however, Treasury proposed new transfer pricing regulations that essentially retained the definition of 'intangible' from before without referencing going concern value or any other residual-business asset, and requested comments on "whether the definition of intangible property . . . should be expanded to include items not normally considered to be items of intellectual property, such as work force in place, goodwill or going concern value."

The court stated that this history rendered the Commissioner's position untenable, noting that the word

'expanded' in the request for comments "confirmed that the then-existing definition of 'intangible' did *not* include residual-business assets."

The court also found relevant the evolution from the 1993 temporary regulations under Section 482, which defined an 'intangible' as "any commercially transferable interest" in an intangible, to the final regulations issued a year later, which left out the 'commercially transferrable' language. The Treasury explanation for the revision was that the omitted language was "superfluous" because "if the property was not commercially transferrable, then it could not have been transferred in a controlled transaction." The Ninth Circuit concluded that this drafting history strongly supported Amazon's position that Treasury limited the definition of 'intangible' to independently transferrable assets.

Observation: Although not specifically addressed by the Ninth Circuit, Amazon and amici curiae had also argued on brief that if the IRS were correct that its purported 'clarification' of the Section 482 regulations in 1994 substantively expanded the definition of an 'intangible,' then Treasury/IRS would have violated the Administrative Procedures Act. Having rejected the IRS's "post hoc interpretation of the changes to the regulatory definition," however, the court stated that it need not address this APA argument.

*Auer d*eference

Lastly, the opinion considered whether the IRS interpretation of the regulatory definition was entitled to *Auer* deference. *Auer* deference refers to the principle that, under certain circumstances, an agency's interpretation of its own regulations must be given controlling weight. Noting that this principle is restricted in certain critical ways, the court provided two reasons why the IRS interpretation of the intangible definition was not entitled to deference.

First, the court found that the rulemaking history it had recounted did not leave a genuine ambiguity that allowed room for the IRS's proffered interpretation. Second, the court applied the principle that deference is not warranted when the timing of an agency's announced interpretation would present an unfair surprise to the regulated parties. Because the IRS court briefs were the first announcement of its view that the regulatory definition embraced residual-business assets, the court found that taxpayers were not given fair warning of the IRS interpretation and thus it was not entitled to deference.

Observation: On March 5, 2019, Treasury and the IRS issued a policy statement asserting the IRS will not seek *Auer* deference in future litigation. This policy statement did not apply to the *Amazon.com* case because the litigation predated the policy statement, but it may further limit the extent to which *Auer* deference is considered in future IRS litigation.

The takeaway

Although the regulatory definition of intangibles at issue in *Amazon.com* has been superseded by new law, the Ninth's Circuit decision resolves a long-standing issue regarding the scope of compensable intangibles under prior law. This decision is important for taxpayers that may have outstanding buy-in issues under the pre-2009 cost sharing regulations, or that have other unresolved issues concerning the scope of compensable intangibles subject to Section 482 or Section 367(d) under pre-2018 law.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing

Gregory J. Ossi, *Washington DC*
+1 202 414 1409
greg.ossi@pwc.com

Andy Kim, *Los Angeles*
+1 650 346 3242
andy.kim@pwc.com

Ward S. Connolly, *San Jose*
+1 650 269 6102
ward.connolly@pwc.com

International Tax Services

Mike DiFronzo, *Washington DC*
+1 202 603 5419
michael.a.difronzo@pwc.com

Marty Collins, *Washington DC*
+1 301 326 6440
marty.collins@pwc.com

Aaron Junge, *Washington DC*
+1 202 739 1053
aaron.junge@pwc.com

Tax Controversy and Dispute Resolution

David Swenson, *Washington DC*
+1 202 431 7114
david.swenson@pwc.com

Our insights. Your choices.

Select 'Tax services' as your *Services and solutions* of interest to receive more content like this.

Set your preferences today

© 2019 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

SOLICITATION

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 158 countries with more than 250,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/US.