Compaq Computer Corp. Subsidiaries v. Commissioner of Internal Revenue

113 T.C. 214

United States Tax Court

BACKGROUND AND FACTS

Petitioner Compaq Computer Corporation manufactures personal computers (PCs). Printed circuit assemblies (PCAs) are the electronic circuitry inside the PC's central processing unit that allows the PC to operate. Compaq set up a PCA manufacturing subsidiary in Singapore. The petitioner purchased PCAs from its Singapore subsidiary at actual market prices based on purchases of similar PCAs from unrelated subcontractors that were primarily located in the United States, with a "turnkey equivalent" adjustment based not on actual transactions, but on industry practice. The Internal Revenue Service took the position that such pricing resulted in too much profit being left in Singapore, a low tax jurisdiction. The IRS argued that a "cost-plus" approach—which would place more profit in the United States—should have been used. Accordingly, the IRS declared a deficiency in Compaq's consolidated returns. Compaq appealed to the Tax Court.

COHEN, CHIEF JUDGE

The issue addressed in this opinion is whether income relating to printed circuit assemblies (PCA's) should be reallocated . . . to petitioner from its Singapore subsidiary for its 1991 and 1992 fiscal years. . . . Unless otherwise indicated, all section references are to the Internal Revenue Code. . . .

Compaq U.S. bought 3.6 million PCA's worth $597 million on a turnkey equivalent basis from unrelated subcontractors. The PCA's were nearly identical to PCA's sold by Compaq Asia to Compaq U.S. After adjustment for differences in physical property and circumstances of the sales, the prices that Compaq U.S. paid to the unrelated subcontractors for PCA's were comparable to the prices that Compaq U.S. paid to Compaq Asia for PCA's.

The issue that we are considering here is whether the transfer prices for PCA's that were charged between Compaq U.S. and Compaq Asia meet the arm's-length standard. . . . Petitioner asserts that [the IRS] notice determinations are unacceptable and that comparable transactions between unrelated parties prove that the transfer prices satisfy the arm's-length standard. . . . [The IRS] asserts that petitioner has not presented comparable uncontrolled prices to prove that its transfer pricing system should be upheld. . . . [The IRS] primary argument is that petitioner's turnkey equivalent analysis is not based on actual transactions . . .

Section 482 gives [the IRS] broad authority to allocate gross income, deductions, credits, or allowances between two related corporations if the allocations are necessary either to prevent evasion of taxes or to reflect clearly the income of the corporations. . . . The applicable standard is arm's-length dealing between taxpayers unrelated by ownership or control. . . .

> The purpose of section 482 is to prevent the artificial shifting of the net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers.
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> the regulations attempt to identify the "true taxable income" of each entity based on the taxable income which would have resulted had the entities been uncontrolled parties dealing at arm's length.* * *

When [the IRS] has determined deficiencies based on section 482, the taxpayer bears the burden of showing that the allocations are arbitrary, capricious, or unreasonable. . . . [The IRS] section 482 determination must be sustained absent a showing of abuse of discretion. . . . "Whether respondent has exceeded its discretion is a question of fact."* * * In reviewing the reasonableness of respondent's determination, the Court focuses on the reasonableness of the result, not on the details of the methodology used.

[The IRS] used unrealistic material, labor, and overhead markups in applying its formulas. If markups in the range of industry markups are used, the results of [IRS] analysis bear no recognizable relation to [the IRS] notice amounts. [Compaq's] analysis establishes an arm's-length price for PCA purchases by Compaq U.S. from Compaq Asia that is approximately $232 million greater than [the IRS] determination in the notice. Due to the significant difference in these arm's-length prices and [the IRS] determination in the notice of deficiency, we conclude that [the IRS]

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allocations lead to an unreasonable result and are thus arbitrary, capricious, and unreasonable.

In addition to proving that the deficiencies set forth in the notice are arbitrary, capricious, or unreasonable, petitioner must also prove that the prices charged by Compaq Asia were consistent with arm's-length pricing. . . . The regulations set forth three pricing methods to determine whether there is an appropriate arm's-length price. First, if comparable uncontrolled sales exist, the regulations mandate that the CUP method be used. If there are no comparable uncontrolled sales, the resale price method must be utilized if the standards for its application are met. If the standards for the resale price method are not satisfied, either that method or the cost-plus method may be used, depending upon which method is more feasible and is more likely to result in an accurate estimate of an arm's-length price. Where none of the three methods can be reasonably applied, some other appropriate method may be used.

Under the CUP method, the arm's-length price of a controlled sale is equal to the price paid in comparable uncontrolled sales including necessary adjustments. "Uncontrolled sales" are sales in which the seller and the buyer are not members of the same controlled group. . . . Uncontrolled sales are considered "comparable" to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales or if such properties and circumstances are so nearly identical that differences either have no effect on price or such differences can be reflected by a reasonable number of adjustments to the price of the uncontrolled sales. Adjustments can be made only where such differences have a definite and reasonably ascertainable effect on price. Some of the differences listed in the regulations as possibly affecting price are differences in quality, terms of sale, intangible property associated with the sale, level of the market, and geographic market in which the sales take place. Whether differences render sales noncomparable depends upon the particular circumstances and property involved. . . .

Petitioner has presented substantial evidence of uncontrolled transactions with unrelated subcontractors. Petitioner's CUP analysis is predicated on Compaq U.S. purchases of 3.6 million PCA's from unrelated subcontractors between 1990 and 1993. The aggregate purchase price of these PCA's totaled $597 million on a turnkey equivalent basis and was 93.1 percent of the Compaq U.S. standard cost. In addition, the purchases occurred in the regular course of business and were substantial in both frequency and amount. . . . Although these transactions were not identical to the controlled transactions involving Compaq Asia, we conclude that they are sufficiently similar to provide a reliable measure of an arm's-length result. Thus, the purchases from unrelated subcontractors identified by petitioner qualify as comparable uncontrolled sales for purposes of application of the CUP method.

Compaq U.S. purchases of PCA's from unrelated subcontractors, however, differ in some respects from the PCA purchases from Compaq Asia. Accordingly, within the context of [tax regulations] and the particular facts in this case, the specific differences between the Compaq U.S. purchase of PCA's from Compaq Asia and unrelated subcontractors must be examined to determine "Whether and to what extent differences in the various properties and circumstances affect price. . . ."

The record demonstrates that the only differences in PCA's within each product category were the particular components used on each individual PCA and the time required to process PCA's on the manufacturing line. We are persuaded that these differences can be corrected with adjustments to Compaq U.S. standard costs. . . .

Based on the uncontrolled purchases of 3.6 million PCA's, the turnkey equivalent price of PCA's purchased from unrelated subcontractors was 93.1 percent of the Compaq U.S. standard costs weighted to the Compaq Asia production amount. Compaq Asia turnkey prices were 93.9 percent of the Compaq U.S. standard cost. Thus, the relationship between Compaq Asia prices and unrelated subcontractors prices is definite, and a reasonably accurate adjustment can be made using these ratios. . . .

Ultimately, [the IRS] argues that, because the CUP method cannot be applied, a profits-based fourth method is the appropriate method of determining arm's-length prices in this case. The Court was faced with the same "prices v. profit" argument [in a prior case]. This Court held:

> The fact that B&L Ireland could, through its possession of superior production technology, undercut

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the market and sell at a lower price is irrelevant. Petitioners have shown that the $7.50 they paid for lenses was a "market price" and have thus "earned the right to be free from section 482 reallocations."
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The same is true in the present case. The CUP method establishes arm's-length prices for PCA's that were sold by Compaq Asia, and a large profit margin does not prevent use of the CUP method.

Decision. The Tax Court found that petitioner satisfied its burden of proving that the prices in the intercompany transactions were consistent with arm's-length prices and ordered the IRS to reduce its deficiency notices accordingly.