Woodward Governor Company v. Commissioner, 55 T. C. 56 (1970)

The arm's-length standard must be used to determine the appropriate transfer price between related entities for tax purposes.

Summary

Woodward Governor Company (WGC) organized a foreign subsidiary, GmbH, to sell aircraft governors directly to European manufacturers, competing with General Electric (GE). The IRS reallocated income from GmbH to WGC, arguing GmbH acted as a commission agent. The Tax Court held that WGC's sales to GmbH were at arm's length, comparable to sales to GE, and that the IRS abused its discretion under Section 482 in reallocating income. The court emphasized the importance of using the comparable uncontrolled price method when applicable, and found the transactions between WGC and GmbH to be substantively similar to those with GE.

Facts

WGC, a U. S. manufacturer of aircraft and nonaircraft governors, established GmbH in Switzerland to sell its Type 1307 aircraft governors directly to European manufacturers of J-79 engines for NATO's Starfighter program. Previously, WGC sold these governors to GE, which resold them to its European licensees. WGC sold the governors to GmbH at the same price as to GE: list price less a 50% discount. GmbH then resold them at a 35% discount. The IRS reallocated income from GmbH to WGC, treating GmbH as a commission agent entitled to only a 7% commission on sales.

Procedural History

The IRS determined a deficiency in WGC's 1963 income tax and reallocated income from GmbH to WGC under Section 482. WGC petitioned the U. S. Tax Court, which heard the case and issued its opinion in 1970, holding for WGC and against the IRS's reallocation.

Issue(s)

1. Whether the IRS abused its discretion in reallocating income from GmbH to WGC under Section 482.
2. Whether WGC's sales of aircraft governors to GmbH were at an arm's-length price.

Holding

1. Yes, because the IRS's determination was arbitrary and lacked justification, as it failed to apply the appropriate arm's-length standard.
2. Yes, because WGC established that its sales to GmbH were at an arm's-length price, comparable to sales to GE.

Court’s Reasoning

The court applied the arm’s-length standard under Section 482 and the regulations, which prioritize the comparable uncontrolled price method. It found WGC’s sales to GmbH comparable to those to GE, as both involved selling at the same market level, with similar terms and responsibilities. The court rejected the IRS’s attempt to use the resale price method, noting it was inapplicable without evidence of uncontrolled transactions. It also dismissed the IRS’s argument that GmbH’s promise to indemnify WGC was less valuable than GE’s, due to lack of evidence on potential liability and financial soundness. The court emphasized that WGC’s sales to GE were profitable, indicating no motive to underprice sales to GmbH. The court concluded the IRS acted arbitrarily in treating GmbH as a mere sales agent and upheld WGC’s pricing as arm’s-length.

Practical Implications

This decision reinforces the importance of using the comparable uncontrolled price method when available in transfer pricing cases. Taxpayers should document comparable transactions with uncontrolled parties to support their pricing. The IRS must justify deviations from this method and cannot rely solely on speculation about differences in substance. The case also highlights the need for taxpayers to consider all relevant factors, including market level, terms of sale, and responsibilities of related parties, when setting transfer prices. Subsequent cases have followed this approach, emphasizing the primacy of the comparable uncontrolled price method in transfer pricing disputes.

