104 T.C. 424

A tax return mailed via certified mail on the due date, but received by the IRS after the normal delivery timeframe, is considered timely filed if evidence suggests a delay in processing by the IRS, thereby validating a cost-sharing election under Section 936 and requiring a cost-sharing payment for product area research.

Summary

Altama Delta Corporation (ADC) and its Puerto Rican subsidiary, Altama Delta Puerto Rico Corp. (ADPR), disputed deficiencies in ADC's federal income taxes. The central issue was whether ADPR validly elected the cost-sharing method under Section 936. ADPR mailed its 1986 tax return, including the cost-sharing election, via certified mail on the extended due date. While other returns mailed the same day were received promptly, ADPR's return was received by the IRS significantly late. The Tax Court held that ADPR's return was timely filed, validating the cost-sharing election. The court also determined that ADPR was required to make a cost-sharing payment to ADC for product area research related to molds, but the failure to make timely payments was not willful neglect. The court further addressed the appropriate transfer pricing method under Section 482, favoring the cost-plus method and imputed interest on excess payments from ADC to ADPR.

Facts

Altama Delta Corporation (ADC) manufactured military boots, and its subsidiary, Altama Delta Puerto Rico Corp. (ADPR), manufactured boot uppers in Puerto Rico, selling them to ADC. For fiscal years 1985-1987, ADPR elected possession corporation status under Section 936. On its 1986 return, ADPR elected the cost-sharing method under Section 936(h)(5)(C), mailing the return via certified mail on the extended due date, June 15, 1987. While other returns mailed simultaneously were received promptly, ADPR's return was received by the IRS Philadelphia Service Center on June 30, 1987. The IRS could not locate the mailing envelope. The IRS challenged ADPR's cost-sharing election as untimely and adjusted transfer prices, arguing ADPR should have made cost-sharing payments for product area research related to boot molds leased from Ro-Search by ADC. ADC contended the return was timely and the transfer prices were appropriate under cost sharing, not requiring a research payment.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Altama Delta Corporation's federal income taxes for fiscal years 1981, 1985, 1986, and 1987. Altama Delta Corporation petitioned the Tax Court contesting these deficiencies, specifically regarding the validity of ADPR's cost-sharing election and the appropriateness of transfer pricing adjustments under Sections 482 and 936.

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Issue(s)

1. Whether ADPR's 1986 federal income tax return, electing the cost sharing method under Section 936(h)(5)(C)(i), was timely filed.
2. Whether ADPR was required to make a cost-sharing payment to ADC for product area research under Section 936(h)(5)(C)(i)(I) for fiscal years 1985-1987.
3. If a cost-sharing payment was required, whether ADPR's failure to make timely payments constituted willful neglect, revoking its cost-sharing election under Section 936(h)(5)(C)(i)(III).
4. What is the proper arm's-length transfer price for uppers sold by ADPR to ADC, and which Section 482 method should be used to determine it?
5. What is the appropriate amount of location savings for ADPR for fiscal years 1985-1987?
6. Whether the IRS properly allocated interest income to ADC from ADPR under Section 482 for fiscal years 1985-1987.

Holding

1. Yes, ADPR's 1986 tax return was timely filed because the evidence of proper mailing and the delayed receipt stamp indicated a processing delay by the IRS, overcoming the presumption of late filing.
2. Yes, ADPR was required to make a cost-sharing payment for product area research because the royalty payments made by ADC to Ro-Search for boot molds constituted product area research costs under Section 936.
3. No, ADPR's failure to make timely cost-sharing payments was not due to willful neglect because it relied on professional advice, and the error was a mistaken interpretation of a complex statute, not willful disregard.
4. The cost-plus method under Section 482 is the appropriate method to determine the transfer price. The court determined an arm's-length gross profit margin for ADPR of 19.2%.
5. The location savings are determined based on the amounts conceded by the IRS, as ADC did not sufficiently prove its claimed amounts.
6. Yes, the IRS properly imputed interest income to ADC on the portion of payments to ADPR exceeding the arm's-length transfer price because this excess was effectively a loan from ADC to ADPR.

Court's Reasoning

The court reasoned that the IRS's received date stamp on ADPR's return was presumptively correct but rebuttable. Evidence showed ADPR mailed the return on time via certified mail, and other returns mailed simultaneously were received promptly. This suggested a delay within the IRS processing, not in mailing, thus the return was deemed timely filed under the presumption of normal mail delivery. Regarding cost sharing, the court determined that royalties paid by ADC to Ro-Search for boot molds were product area research costs under Section 936,

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necessitating a cost-sharing payment from ADPR. However, ADPR's failure to pay was not willful neglect; it was based on advice from accountants who mistakenly interpreted the complex statute. The court found the cost-plus method to be the most appropriate Section 482 method for transfer pricing, rejecting both experts' methodologies but using the cost-plus framework with comparable gross profit margins from the military boot industry. The court set ADPR's arm's-length gross profit margin at 19.2%, based on ADC's average profit margin, adjusting for risk and functions. Location savings were limited to IRS conceded amounts due to insufficient proof from ADC. Finally, the court upheld imputed interest on excess payments from ADC to ADPR, treating the overpayment as a loan.

Practical Implications

Altama Delta Corp. v. Commissioner offers several practical takeaways for tax practitioners and businesses operating under Section 936 and Section 482:

- **Timely Filing Evidence**: Meticulous documentation of mailing tax returns, especially certified mail receipts, is crucial. This case highlights that even a late IRS received stamp can be overcome with sufficient evidence of timely mailing, particularly when multiple mailings demonstrate normal delivery times for other items mailed concurrently.
- **Cost Sharing Obligations**: Companies electing cost sharing under Section 936 must diligently identify and calculate product area research costs, including payments for intangibles. Royalties for intellectual property, like the boot molds in this case, clearly fall under product area research.
- **Willful Neglect Standard**: Reliance on professional advice, even if ultimately incorrect, can protect against a finding of willful neglect in failing to make cost-sharing payments, preserving the validity of the Section 936 election. However, the advice must be based on reasonable research and analysis.
- **Transfer Pricing Methodology**: The case reinforces the priority of specified methods under Section 482 regulations, particularly the cost-plus method for manufacturing scenarios. It underscores the importance of using gross profit margins when appropriate comparables are available and cautions against using operating profit margins when gross profit data is more relevant. Comparables should be carefully selected within the same industry and functional profile.
- **Location Savings Substantiation**: Taxpayers claiming location savings bear the burden of proof and must provide detailed evidence to support their calculations, beyond mere accountant summaries.
- **Imputed Interest on Transfer Pricing Adjustments**: Excessive transfer prices can be recharacterized as loans, triggering imputed interest income under Section 482. Companies must ensure intercompany transactions reflect arm's-length pricing to avoid such implications.

This case serves as a reminder of the complexities of Section 936 and Section 482, emphasizing the need for careful compliance, robust documentation, and reasoned

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expert analysis in intercompany transactions and possession corporation operations.

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