Altama Delta Corp. v. Commissioner, 105 T. C. 186 (1995)

A taxpayer's timely mailing of a tax return is deemed timely filing, and the cost sharing method under section 936(h) requires a subsidiary to make payments for product area research to its parent.

Summary

Altama Delta Corp. (ADC) and its subsidiary, Altama Delta Puerto Rico Corp. (ADPR), were involved in a dispute over the transfer pricing of combat boot uppers and the validity of ADPR's cost sharing election under section 936(h). The court held that ADPR's tax return was timely filed due to the timely mailing presumption and that ADPR was required to make cost sharing payments to ADC for product area research related to the use of molds under a licensing agreement with Ro-Search. The court also determined that ADPR's failure to make these payments was not due to willful neglect, thus not revoking its cost sharing election. The transfer prices for the uppers were set at a gross profit margin of approximately 19. 2%, reflecting an arm's-length transaction. The decision underscores the importance of proper documentation and adherence to IRS regulations in intercompany transactions and tax elections.

Facts

ADC, a Georgia corporation, manufactured combat boots and had a subsidiary, ADPR, which produced the boot uppers in Puerto Rico. ADPR made a cost sharing election under section 936(h) on its 1986 tax return, which was due on June 15, 1987. ADPR's accountants mailed the return on June 15, 1987, but it was received by the IRS on June 30, 1987. ADC paid royalties to Ro-Search for the use of molds used in the boot manufacturing process. ADPR did not make cost sharing payments to ADC for these royalties, which ADC had deducted as product area research costs. The IRS challenged the transfer pricing between ADC and ADPR and the validity of ADPR's cost sharing election.

Procedural History

The IRS issued a notice of deficiency to ADC for the fiscal years 1985, 1986, and 1987, asserting adjustments to the transfer prices of the boot uppers and denying the validity of ADPR's cost sharing election. ADC contested these adjustments in the U. S. Tax Court, which ruled in favor of ADC on the timeliness of ADPR's 1986 tax return filing and the validity of the cost sharing election, but adjusted the transfer prices to reflect an arm's-length standard.

Issue(s)

1. Whether ADPR timely filed its Federal income tax return for its fiscal year ending September 27, 1986, to make a valid cost sharing election under section 936(h)(5)(C)(i).

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2. Whether ADPR was required to make cost sharing payments to ADC for product area research under section 936(h)(5)(C)(i)(I).
3. Whether ADPR's failure to make timely cost sharing payments was due to willful neglect, causing its cost sharing election to be revoked under section 936(h)(5)(C)(i)(III).
4. What is the proper amount of the transfer price of products transferred from ADPR to ADC and the appropriate section 482 method of determining that price.
5. What is the amount of location savings to which ADPR is entitled for each of the fiscal years in issue.
6. Whether, for petitioner's fiscal years 1985, 1986, and 1987, respondent properly allocated interest income to petitioner from ADPR under the provisions of section 482, and, if so, the proper amounts to be allocated.

Holding

1. Yes, because ADPR's return was timely mailed on June 15, 1987, and thus deemed timely filed under the timely mailing presumption.
2. Yes, because ADC's payments to Ro-Search for the use of molds constituted product area research costs under section 936(h)(5)(C)(i)(I).
3. No, because ADPR's failure to make timely cost sharing payments was not due to willful neglect, as the officers relied on the advice of their accountants.
4. The proper transfer price is based on a gross profit margin of approximately 19. 2%, determined using the cost-plus method under section 482.
5. ADPR is entitled to location savings as conceded by the IRS, but petitioner failed to prove the claimed amounts.
6. Yes, because the excess sales proceeds transferred from ADC to ADPR were effectively a loan, and thus interest should be imputed under section 482.

Court's Reasoning

The court applied the timely mailing presumption under section 7502, concluding that ADPR's tax return was timely filed despite the IRS's June 30, 1987, received stamp. The court determined that ADC's payments to Ro-Search for molds were product area research costs, requiring ADPR to make cost sharing payments under section 936(h)(5)(C)(i)(I). ADPR's failure to make these payments was not due to willful neglect, as the officers relied on their accountants' advice. The court used the cost-plus method under section 482 to determine the transfer price, setting ADPR's gross profit margin at approximately 19. 2% based on ADC's profit margins and industry comparables. The court rejected the IRS's proposed allocation as arbitrary and unreasonable. Location savings were limited to the amounts conceded by the IRS due to lack of proof by petitioner. Finally, the court upheld the IRS's allocation of interest income to ADC under section 482, treating the excess sales proceeds as a loan to ADPR.

Practical Implications

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This decision emphasizes the importance of timely mailing of tax returns and proper documentation to support tax elections. It clarifies that subsidiaries must make cost sharing payments for product area research costs incurred by the affiliated group. The court's use of the cost-plus method under section 482 provides guidance on determining arm's-length transfer prices, particularly in industries with unique characteristics like the combat boot market. Practitioners should be aware that reliance on professional advice can mitigate claims of willful neglect. The case also highlights the need for thorough substantiation of location savings and the potential for interest income allocation under section 482 in intercompany transactions.

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