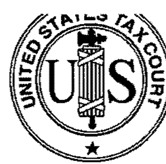
ALS  US TAX COURT
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SEATTLE
DEC 15 2014

AMAZON.COM, INC. & SUBSIDIARIES
Petitioner(s)

PAPER FILED

v.

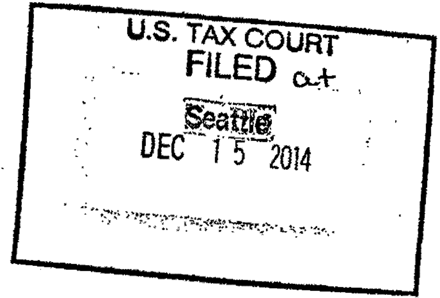
Docket No. 31197-12

COMMISSIONER OF INTERNAL REVENUE,
Respondent

TRIAL MEMORANDUM

SERVED Apr 07 2015

Protected Information Subject to Protective Order



UNITED STATES TAX COURT

AMAZON.COM, INC. & SUBSIDIARIES,	)	
	)	
Petitioner,	)	
	)	
v.	)	Docket No. 31197-12
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	Judge Lauber
	)	
	)	
Respondent.	)	

RESPONDENT'S TRIAL MEMORANDUM

ISSUES FOR TRIAL

1. Whether respondent's determination that $3.6 billion is an arm's length price for the intangible property used in petitioner's European websites business that petitioner transferred or made available to its newly formed Luxembourg subsidiary in 2005 is arbitrary and capricious.[1]

2. Whether respondent's determination that petitioner omitted costs related to intangible development under its qualified cost sharing arrangement ("QCSA") in computing the cost sharing payments due from the Luxembourg subsidiary in the amounts of $23,032,018 and $109,889,346 in 2005 and 2006, respectively, is arbitrary and capricious and whether petitioner's claim to reduce the 2005 cost sharing payment by $59,752,000 should be denied.

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[1] Petitioner reported compensation for the transfer over a seven year period. Respondent's adjustments for the 2005 and 2006 tax years are $1,036,305,000 and $1,170,251,000, respectively.

3. Whether petitioner's claim to reduce its 2005 and 2006 cost sharing payments from its Luxembourg subsidiary in the amounts of $2,545,000 and $6,951,000, respectively, by excluding stock-based compensation ("SBC") related to intangible development from the pool of intangible development costs ("IDCs") should be denied.

Petitioner has agreed to respondent's determinations as to the arm's length compensation required for acquisition buy-in intangibles. The parties filed a Stipulation of Settled Issues on May 30, 2014 with respect to this issue.

SUMMARY OF FACTS

The issues for trial arise from Project Goldcrest, petitioner's migration of the intangible property used in its European retail and service website businesses from the United States ("U.S.") to a newly-formed Luxembourg affiliate, Amazon Europe Holding Technologies SCS ("AEHT"). A key feature of Project Goldcrest was the transfer of rights to use that property in intangible development in a QCSA. United States tax law required AEHT to pay petitioner an arm's length price for the intangibles. Treas. Reg. §§ 1.482-1, 1.482-4, 1.487-7A.[2] Petitioner based its tax reporting on a value of only $217

[2] All regulation references are to those in effect during the years in issue. Section 1.482-7 was renumbered section 1.482-7A with the promulgation of new regulations effective as of January 5, 2009. See T.D. 9441, 2009-7 I.R.B. 460.

million for the entire bundle of European website intangibles. Respondent determined that the bundle was worth $3.6 billion. United States tax law also required AEHT to pay petitioner for its share of all IDCs. Petitioner did not keep records of IDCs. Instead it applied allocation ratios to "cost centers" without establishing that they contained non-IDCs, systematically understating its cost pools and thus AEHT's payments.

Petitioner's Business. Amazon.com, Inc. ("ACI")[3] was incorporated on July 5, 1994. It began operating in 1995 as an online retailer of books through the domain name (also called web address or URL) "Amazon.com." Amazon[4] was founded by Jeffrey P. Bezos who continues to serve as Chairman of its Board and CEO. Amazon completed an initial public offering on May 15, 1997 at an implied market value of $438 million. Its common stock has traded on the Nasdaq National market since that time.

Petitioner is, and was during the years in issue, a leading e-commerce retailer in the U.S. and in Europe. From inception, Amazon's stated business strategy was to use technology to create a lasting brand. By 1999, less than a year after Amazon launched its European websites, it announced that it had met its goal:

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[3] ACI is the common parent of the Amazon U.S. Group. Unless specifically noted, the use of the terms in this memorandum is consistent with the stipulation of facts lodged by the parties.
[4] "Amazon" refers to all or some members of the worldwide group of controlled corporations of which ACI is the common parent.

> The Amazon.com platform is comprised of brand, customers, technology, distribution capability, deep e-commerce expertise, and a great team with a passion for innovation and a passion for serving customers well . . . . We believe we have reached a "tipping point," where this platform allows us to launch new e-commerce businesses faster, with a higher quality of customer experience, a lower incremental cost, a higher chance of success, and a clearer path to scale and profitability than perhaps any other company.[5]

Amazon set out to be and became the world's most customer-centric company, offering customers the greatest possible selection at the lowest possible prices with great convenience.

In the years leading up to the Project Goldcrest restructuring, Amazon invested more than a billion dollars to create a state of the art e-commerce platform that could be leveraged across an unlimited number of new products. Amazon provides value through product selection, low prices, personalized service, convenient and reliable online and offline customer service, community reviews and recommendations. Amazon collects information about customers' tastes and spending habits that it uses to advertise and target customers and in its back-end systems. Mr. Bezos explained in his 2005 Letter to Shareholders that "many of the important decisions we make at Amazon.com can be made with data."[6] Petitioner also grew by acquiring software, catalogs, know-how and other intangibles through acquisitions of other firms.

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[5] Ex. 3-J (1999 Letter to Shareholders and Form 10-K).
[6] Ex. 9-J (2005 Annual Report).

Amazon established its European business in April 1998 by acquiring online bookstores operating in the U.K. (Bookpages Ltd.) and Germany (Telebook, Inc.). In October 1998, Amazon re-launched the Bookpages and Telebook websites under the domain names "Amazon.co.uk" and "Amazon.de." In August 2000, Amazon launched an online retail business aimed at the French market through the French-language website "Amazon.fr." As Amazon expanded, it offered additional product categories for sale on its U.S. and EU websites. Amazon launched virtually every product category first in the U.S. and then later in Europe.

In 1996, Amazon launched its Amazon Associates syndicated selling program. The program used third-party Associates to draw traffic to Amazon by recommending Amazon products to visitors to the Associates' websites in exchange for referral fees. In addition to its retail business of selling products online, Amazon also provided third parties with a set of e-commerce platforms, services or tools for the sale of the third-parties' goods and services. Amazon initially located merchandise offered by third parties in separate areas of its website in tabs titled "Auctions" and "ZShops." In 2000, Amazon gave its third-party sellers access to the "product-detailed" pages inside its traditional stores by listing the sellers' products alongside Amazon's.

Amazon's third-party sellers business (the "3PS Business") included the Marketplace program, serving individuals and small businesses, and the Merchants@ program, for large businesses. These programs provided Amazon with an additional revenue stream of commissions and fees without incurring inventory risks and fulfillment costs. By partnering with other online enterprises, Amazon created a bigger customer base and thus a larger business.

Amazon's 3PS Business also included the Merchant.com program in which Amazon utilized its e-commerce services, features and technologies to operate another business' website, sell that business' products under its own brand name and website address, and sometimes offer fulfillment services. Amazon was not the seller of record but instead earned fixed fees, sales commissions, per-unit activity fees, or some combination thereof. Amazon's 2001 agreement with Target Stores is an example of such an arrangement. The Associates program and the 3PS Business were launched in Europe before Project Goldcrest.

<u>Amazon Pre-Project Goldcrest.</u> Prior to the completion of Project Goldcrest on the April 30, 2006 Business Transfer Date, Amazon operated its EU Websites Business through two wholly-owned subsidiaries. Amazon.com Int'l Sales, Inc. ("AIS") was the inventory owner and seller of record for the European retail

business. Amazon.com Int'l Marketplace, Inc. ("AIM") recognized the gross income and deductions of the international 3PS Business. AIS and AIM licensed the intellectual property related to the EU Websites Business from another U.S. subsidiary, Amazon Technologies, Inc. ("ATI"). Amazon.co.uk Ltd., Amazon.de GmbH, Amazon Logistik GmbH, Amazon.fr Sarl and Amazon Logistique SAS (the "EU Operating Subsidiaries") engaged in sales, fulfillment and other routine activities in the U.K., Germany and France as needed to operate the website businesses in those countries and were compensated by AIS and AIM pursuant to a series of intercompany agreements generally on a cost plus basis. Most Amazon employees in Europe worked in warehouses and virtually all research and development was done in the U.S.

By 2004, Amazon was the world's largest global Internet retailer with 9,000 employees and worldwide sales of $6.9 billion - three times as much as its closest competitor. Amazon first reported positive net operating income in 2003 and again in 2004 while still focusing on "free cash flow" over the long term. Amazon's stock market capitalization was almost $16 billion by the end of 2004. In 2004, the Interbrand consultancy firm valued the Amazon brand at $4.156 billion.

As early as 1999, Amazon had anticipated expanding its European operations. Revenues in Europe were [redacted] by 2004 and accounted for [redacted] of Amazon's worldwide revenues.

Amazon management projected [redacted] growth in European revenues. By 2004, Amazon had annual profits in Europe of [redacted]

Project Goldcrest. Amazon undertook a twenty-eight step reorganization that restructured its European business beginning in 2004. The restructuring was completed on May 26, 2006 (the "Business Transfer Date"). The plan, described in presentations to the Audit Committee of ACI's Board of Directors and ACI executives beginning in September 2003, was to form a central headquarters company located in Luxembourg to own and operate Amazon's EU websites. An additional layer of management would be created and located in Luxembourg, to whom the heads of the French, German and U.K. retail operations would report. Web servers would be moved to Ireland and Luxembourg.

Amazon formed Luxembourg entities to implement the restructuring. AEHT, a Luxembourg controlled foreign corporation for U.S. tax purposes by virtue of a check-the-box election (a pass-thru entity for purposes of local Luxembourg law) was formed on June 7, 2004, to hold the Amazon European intangible property ("IP"). Amazon EU Sarl ("AEU"), taxable for Luxembourg purposes (but disregarded for U.S. purposes), was formed to conduct the EU Websites Business previously carried out by AIS and AIM.

AEHT licensed the European IP to AEU. In 2003, Amazon approached the Luxembourg tax authorities to discuss taxation of its European businesses. It was agreed that AEU would be taxed on a routine income amount equal to cost plus 4.5 percent to 5.5 percent. All of the remaining income from Amazon's European operations was paid to AEHT as a royalty in the range of [redacted] [redacted] and was not taxed in Luxembourg or in the U.S.

Petitioner's Finance staff analyzed the expected costs and benefits of Project Goldcrest using various transaction dates, buy-in valuations and business projections. They computed the projected net present value ("NPV") of the "cash tax" and financial statement benefits based on the same projections Finance was developing to compute the buy-in. They computed the incremental costs of Project Goldcrest. They did not quantify any benefits other than avoided U.S. corporate income taxes.

Three intercompany agreements relate to the EU websites' IP that petitioner transferred to AEHT in Project Goldcrest: a Cost Sharing Agreement, a License Agreement and an Assignment Agreement. See Exs. 51-J, 53-J through 56-J.

Cost Sharing Agreement. In December 2004, A9.com, Inc. ("A9"), an ACI subsidiary, and AEHT entered into an "Agreement to Share Costs and Risks of Intangible Development."[7] Effective January 1, 2005, A9, AEHT, and ATI entered into an "Amended and

[7] Ex. 51-J.

Restated Agreement to Share Costs and Risks of Intangible Development."[8] Petitioner structured its cost sharing agreement to qualify as a QCSA. See sections 1.482-7A(a)(1), 1.482-7A(b).[9] As QCSA participants, the parties agreed "to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits" from exploiting their respective interests in the intangibles assigned to them under the arrangement. Section 1.482-7A(a)(1).

The QCSA obligated the parties to share in all current and future development costs in proportion to "the ratio of benefits realized or forecasted for [each] such Party over the total benefits realized or forecasted for the Parties."[10] Development costs "include all direct and indirect costs (including Stock-Based Compensation Costs ...), incurred ... for activities performed pursuant to the Development Program, ... as determined in accordance with United States generally accepted accounting principles ... ."[11] The scope of the Development Program was broadly defined in the QCSA as "all research, development, marketing and other activities relating to the Licensed Purpose

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[8] Ex. 53-J.
[9] Respondent is limited in making allocations with respect to a QCSA to allocations necessary to make each participant's share of intangible development costs equal to its share of reasonably anticipated benefits from such development. Section 1.482-7A(a)(2).
[10] Ex. 53-J, § 4.3.
[11] Ex. 53-J, § 3.3(a).

. . . ."[12] The Licensed Purpose for AEHT was defined to include European operations and for ATI and A9, the rest of the world.[13] Petitioner's QCSA assigned the right to exploit the co-developed intangibles in Europe to AEHT and the exploitation rights in the rest of the world to the U.S. participants.[14] Petitioner's share of "reasonably anticipated benefits" from intangible development under the QCSA averaged 31 percent during the years in issue.

License Agreement. AEHT and ATI entered into a "License Agreement For Preexisting Intellectual Property with ATI" ("License Agreement") also effective as of January 1, 2005, in which ATI granted AEHT "certain intellectual property rights for the use of Amazon Intellectual Property," other than certain "Excluded Intellectual Property."[15] Pursuant to the License Agreement, "Amazon Intellectual Property" in existence prior to the effective date was made available to the cost sharing participants to facilitate the joint development of the cost-shared IP. Amazon Intellectual Property was defined broadly to include "any and all intellectual property rights" (other than "Excluded Intellectual Property"), including but not limited to:

> [C]opyrights (including but not limited to reviews and editorial content), trade secrets, trademarks, patents, inventions, designs, trade dress, "moral right," mask works, rights of personality, publicity

[12] Ex. 53-J, § 2.1.
[13] Ex. 53-J, § 1.13.
[14] Ex. 53-J, § 6.
[15] Ex. 55-J.

> or privacy, rights in associate or vendor information, rights in customer information (including but not limited to customer lists and customer data) and any other intellectual property and proprietary rights (including but not limited to rights in databases, marketing strategies and marketing surveys).[16]

Assignment Agreement. Also effective January 1, 2005, AEHT and ATI entered into an "Assignment Agreement for Preexisting Intellectual Property" ("Assignment Agreement") in which ATI assigned AEHT the "Excluded Intellectual Property" referred to in the License Agreement as of the Business Transfer Date.[17] The assigned property included copyrights on the content (but not the underlying code) associated with the EU websites, certain trademarks and trade dress and domain name registrations relating to the EU Websites Business. April 30, 2006 was subsequently chosen as the Business Transfer Date.[18] Also on the Business Transfer Date, the EU Operating Subsidiaries assigned domain name and trademark registrations to AEHT and also licensed to AEHT certain editorial content related to the EU websites for a lump sum payment of less than $1 million.

Post-Restructuring. After the Business Transfer Date, petitioner no longer included the gross income and deductions of

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[16] Ex. 55-J, § 1.2.
[17] Ex. 56-J.
[18] Petitioner did not file a Form 926 or a section 351 statement with any U.S. tax return specifying that any asset covered by the License Agreement or Assignment Agreement or otherwise made available to the QCSA was contributed to AEHT via a section 351 exchange. Rather, petitioner reported that AEHT and Amazon became cost sharing participants under section 1.482-7A(j)(3).

the EU Websites Business in its consolidated U.S. tax returns. AEU held the inventories and, through newly-formed Irish subsidiaries, the data centers. AEU contracted with the EU Operating Subsidiaries to provide the marketing support, customer support, and fulfillment services they previously rendered to AIS and AIM on a cost plus basis. Most of Amazon's research and development continued to be performed by employees in the U.S.[19]

Since the years in issue, Amazon has expanded its businesses to include Amazon Web Services ("AWS" or "cloud computing") and its Kindle e-reader. The development of AWS and Kindle was discussed by Amazon's Board during the years in issue.

Tax reporting/valuation. ACI engaged Deloitte Tax LLP ("Deloitte") to prepare transfer pricing studies in connection with the restructuring.[20] Deloitte concluded that the IP transferred to AEHT had an NPV of $216,711,000 as of January 1, 2005. Deloitte described the IP made available to AEHT in the restructuring and subject to the buy-in as "[a]ll Pre-Existing IP and Assigned IP currently utilized in the EU Website Businesses"[21] and performed an aggregate valuation of that IP.

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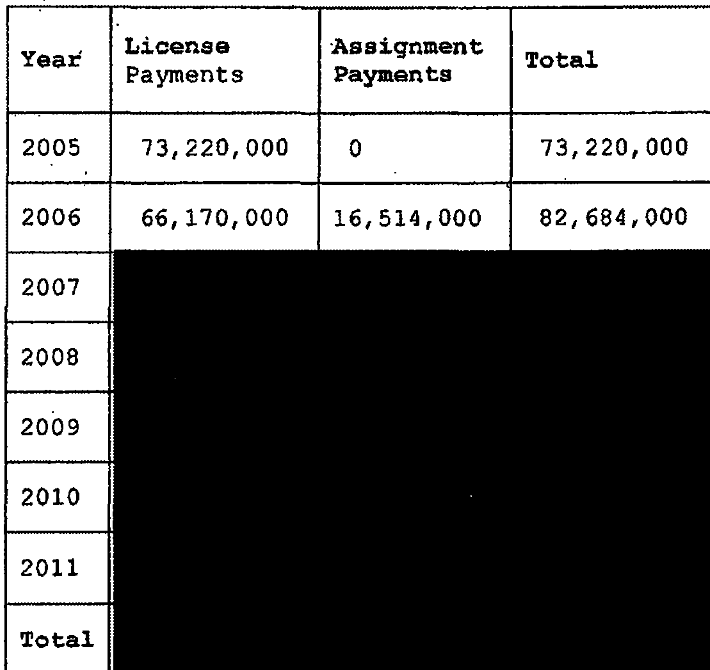
[19] Cost plus fees paid to foreign development affiliates were included in the cost pool and are not at issue.
[20] See, e.g., Ex. 57-J.
[21] Ex. 57-J, p. 25.

Relying on the financial projections prepared by Amazon management in connection with Project Goldcrest, Deloitte selected an unspecified income-based method and a 7-year useful life for the IP. Deloitte determined that a 4.5 percent mark-up on costs for the EU Operating Subsidiaries was an arm's length return. It subtracted that amount from Amazon's 7-year operating profit and applied a ramp down or decay curve to attribute the resulting projected income between ACI and AEHT. Because of Deloitte's steep ramp down curve, over half of the value contributed by the pre-existing intangibles was gone after two years.[22] Petitioner used the Deloitte report as the basis

[22] The compensation based on the Deloitte Transfer Pricing Study is combined in the table below.



Year	License Payments	Assignment Payments	Total
2005	73,220,000	0	73,220,000
2006	66,170,000	16,514,000	82,684,000
2007			
2008			
2009			
2010			
2011			
Total			

for its federal income tax reporting for the years in issue and provided it to respondent to substantiate its reported buy-in.

Cost Sharing Payments. On its 2005 and 2006 income tax returns, petitioner reported cost sharing payments from AEHT of $116,092,584 and $77,297,000. Petitioner did not keep contemporaneous records of IDCs. Rather than identify and record these IDC costs as they were incurred, petitioner applied allocation ratios to the total costs of selected cost centers that petitioner contends contain both IDCs and non-IDCs to determine the amounts of costs required to be shared under its QCSA (the "cost pool"). Petitioner's 2005 reporting position allocated costs to the cost pool based on the percentage of employees within a particular cost center who were designated as "T" code or "technical" employees.

After it started cost sharing, petitioner hired PricewaterhouseCoopers LLP ("PwC") to perform a research credit study to support an I.R.C. § 41 refund claim. Petitioner used the results of PwC's employee surveys and qualified research expense ("QRE") ratio to devise a second ratio that further reduced the costs allocated to the cost pools. Petitioner's ratios allocate less than half of its 2005 and 2006 Technology and Content costs -- consisting "principally of payroll and related expenses for employees involved in research and development, including application development, editorial

content, merchandising selection, systems and telecommunications support, and costs associated with the systems and telecommunications infrastructure"[23] -- to intangible development. Petitioner never conducted any sampling or testing to determine whether its allocation ratios in fact captured all IDCs.

Stock-Based Compensation. Petitioner's cost centers included costs related to restricted stock units ("RSU"), a type of SBC that it paid to employees engaged in intangible development. Petitioner used the same allocation method to determine the amount of RSU costs to include in the cost pools.

Audit and Notice of Deficiency. Respondent retained Dr. Daniel Frisch, a PhD economist and transfer pricing expert, to assist in the examination of petitioner's reported buy-in payment. Using an unspecified income-based method known as a discounted cash flow ("DCF"),[24] Dr. Frisch started with Amazon Finance's income projections and the routine returns to EU Operating Subsidiaries' functions used by Deloitte. To adjust Amazon's operating profit projections to derive cash flows, Dr. Frisch reduced the projected cash flows by capital investments, including projected cost sharing payments provided by Amazon management. From that amount, he subtracted the book value of

[23] Ex. 9-J (2005 Annual Report, p. 60).
[24] Dr. Frisch used the comparable uncontrolled transaction and market multiple methods to corroborate his DCF.

tangible assets and the cost plus return to the EU Operating Subsidiaries calculated by Deloitte and used in Amazon's intercompany service agreements to derive the intangible cash flows attributable to the EU Websites Business. Applying a conservative 3.8-percent terminal year growth rate in 2011 and a conservative 18-percent discount rate to these cash flows, Dr. Frisch concluded that petitioner would have licensed the transferred IP to an uncontrolled party for a NPV of $3.6 billion. AEHT owned no intangibles prior to the restructuring; its only expected contribution was cash for its share of IDCs incurred by ACI that were estimated by Amazon based on 2004 operating plans. Dr. Frisch's analysis gives AEHT an 18-percent return on its projected IDCs and allocates the remaining cash flows attributable to the intangibles transferred by ACI.

Petitioner failed to substantiate the amount of IDCs that AEHT was required to share under section 1.487-7A(d)(1). Respondent increased cost sharing payments from AEHT by adjusting petitioner's 2005 and 2006 cost pools to include all of its Technology and Content ("T&C") costs and denied petitioner's claims.[25]

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[25] Petitioner filed administrative claims to reduce its 2005 cost sharing payments by $56,469,000 based on the QRE ratio and its 2005 and 2006 cost sharing payments by $2,545,000 and $6,951,000, respectively, by excluding SBC.

RESPONDENT'S LEGAL POSITION

Buy-In Issue

The ultimate question "in every case" under section 482 is whether the result claimed by the controlled taxpayers is the "arm's length result." Section 1.482-1(b). The issue before the Court in this case is the price that would be paid between unrelated parties for the intangibles ACI transferred to AEHT in the restructuring on January 1, 2005. Petitioner transferred all of the intangibles used in its EU Websites Business to AEHT as part of a transfer of that entire business to Luxembourg. Prior to that date, AEHT owned no intangibles as a matter of economics and tax law. Any intangibles held by the Amazon subsidiaries operating in Europe had been developed at petitioner's expense and risk. Before the Business Transfer Date, all of the income from the European business was reported by petitioner. Afterwards, it was all reported by AEHT. The section 482 regulations require AEHT to pay for what it received in the restructuring. Sections 1.482-1, 1.482-4, and 1.482-7A.

The applicable cost sharing regulations require payment of an "arm's length charge" for the use of pre-existing intangible property made available "for purposes of research in the intangible development area" under a QCSA. Section 1.482-7A(g)(2). Section 1.482-4(b) defines intangibles broadly and does not exclude anything in the bundle of intangibles used in

Amazon's EU Websites Business. Petitioner's interpretation of these regulations -- that it can transfer valuable intangible property to its Luxembourg subsidiary without compensation-- is contrary to the the arm's length standard and statutory and regulatory intent and must be rejected. See Xilinx, Inc. v. Commissioner, 598 F.3d 1191 (9th Cir. 2010) (rejecting Service's interpretation of a cost sharing regulation found by the court to conflict with section 1.482-1).

Section 482 and the Applicable Regulations. Respondent's section 482 allocation must be sustained absent a showing of abuse of discretion. VERITAS Software Corp. v. Commissioner, 133 T.C. 297, 318 (2009), non-acq., IRB No. 2010-49 (Dec. 6, 2010); Sundstrand Corp. & Subs. v. Commissioner, 96 T.C. 226, 353 (1991); Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525, 582, aff'd, 933 F.2d 1084 (2d Cir. 1991). Thus, to prevail petitioner first must show that respondent's section 482 allocation is arbitrary, capricious, or unreasonable. Sundstrand, 96 T.C. at 353-354 (citing G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 359 (1987), and Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1131, aff'd in part, rev'd in part and remanded 856 F.2d 855 (7th Cir. 1988)). If petitioner meets that burden, it then must prove that the allocation it proposes meets the arm's length standard. VERITAS, 133 T.C. at 318; Sundstrand, 96 T.C. at 354.

Section 482 authorizes the Service to allocate income, deductions, and other tax items among controlled taxpayers to prevent evasion of taxes or to clearly reflect income. Sections 482, 1.482-1(a)(1). Section 1.482-1(b) states that "the standard to be applied <u>in every case</u> is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." (Emphasis added). A controlled transaction meets the arm's length standard "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)." <u>Id.</u> Section 1.482-7A provides the specific method to be used to evaluate whether a QCSA produces results consistent with an arm's length result. Section 1.482-1(b)(2).

<u>Cost Sharing Regulations: Section 1.482-7A.</u> Section 1.482-7A provides the transfer pricing rules that applied to QCSAs in the 2005 and 2006 tax years before the Court. A QCSA does not produce an arm's length result unless participants share all IDCs (as determined under section 1.482-7A(d)) in proportion to their reasonably anticipated benefits (determined under sections 1.482-7A(e) and (f)(the "RAB share")) <u>and</u> participants make an arm's length buy-in payment for intangible property made available by other participants for use in intangible

development pursuant to the arrangement. Section 1.482-7A(a)(3). Buy-in payments are required if:

> [A] controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement ... .

Section 1.482-7A(g)(2). An "interest in an intangible" includes "any commercially transferable interest, the benefits of which are susceptible to valuation." Section 1.482-7A(a)(2). The buy-in payment required of each controlled participant is the arm's length charge for the use of the pre-existing intangible, as determined under the rules of section 1.482-1 and sections 1.482-4 through 1.482-6, multiplied by the controlled participant's RAB share. Section 1.482-7A(g)(2).

Under the regulatory framework, every intangible is either a pre-existing or covered intangible. A "covered intangible" is any intangible property that is developed as a result of the research and development undertaken under the QCSA. Section 1.482-7A(b)(4)(v). Pre-existing intangibles are intangibles that are not covered intangibles and include intangibles made available at the outset of the QCSA as well as intangibles that are made available later. Section 1.482-7A(g)(2).

Congress explained why buy-in payments are required to reach an arm's length result in a QCSA:

> [T]o the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.

H.R. Conf. Rep. No. 99-841, at 638 (1986), as reprinted in 1986 U.S.C.C.A.N. 4075, 4726. Without arm's length compensation, the pre-existing intangibles that are brought by one controlled participant to cost sharing would provide a "head start" to the other controlled participants at the risk and expense of the first. Cost sharing payments do not compensate for pre-existing intangibles, which result from expenses and risk incurred prior to the QCSA. In a QCSA, the cost sharing payments plus the buy-in payments stand in place of the price that the controlled taxpayers are required to pay for the covered intangibles. Cf. VERITAS, 133 T.C. at 315.

ACI incurred more than a billion dollars of expenses and put its funds at risk to develop its e-commerce platform and its marketing intangibles for a ten year period prior to the restructuring. Without a buy-in payment for the value of the right to use those pre-existing intangibles in the development of covered intangibles under the QCSA, ACI's compensation is not arm's length and AEHT receives a windfall.

Best Method. The arm's length result for a particular controlled transaction or group of controlled transactions is

determined by applying the most reliable transfer pricing method, taking into account the specific facts and circumstances, the completeness and accuracy of the available data, and the reliability of any assumptions used in the analysis. Section 1.482-1(c)(2) ("the best method"). The regulations do not impose a "strict priority of methods," and provide that "no method will invariably be considered to be more reliable than others." Section 1.482-1(c)(1). Section 1.482-4(a) specifies three methods for pricing transfers of intangible property: (1) the comparable uncontrolled transaction ("CUT") method; (2) the comparable profits method; and (3) the profit split method. An unspecified method described in section 1.482-4(d) should be used if the unspecified method provides a more reliable measure of an arm's length result. Section 1.482-1(c)(1).

Each of the methods must be applied in accordance with all of the provisions of section 1.482-1, including the best method rule of section 1.482-1(c), the comparability analysis of section 1.482-1(d), and the arm's length range of section 1.482-1(e). The method must take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable. Section 1.482-4(d)(1). Section

1.482-1(f)(2)(ii)(A) provides that the Commissioner "may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances." The realistic alternatives principle mirrors the valuation principle that independent third parties compare alternatives in making decisions about whether to invest, approve projects, or conclude transactions.

Aggregation. Controlled transactions may be aggregated if aggregation provides the most reliable measure of an arm's length result. Section 1.482-1(f)(2)(i). An aggregate analysis may be particularly useful in a case that involves several controlled transactions, each of which is difficult to value separately. In such a case, applying one transfer pricing method to two or more transactions may be more reliable than pricing separate controlled transaction in isolation. Id. Aggregation is appropriate here. The transfer to AEHT involved an undifferentiated bundle of interrelated intangible property. The bundle included "make-sell" rights to use the property in the continuing EU Websites Business and to use the property and their derivative works in further research and development.

Section 482 Definition of Intangibles. Intangibles are broadly defined in section 1.482-4(b) as:

> [A]n asset that comprises any of the following items and has substantial value independent of the services of any individual--
>
> (1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
>
> (2) Copyrights and literary, musical, or artistic compositions;
>
> (3) Trademarks, trade names, or brand names;
>
> (4) Franchises, licenses, or contracts;
>
> (5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
>
> (6) Other similar items. <u>For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.</u> (Emphasis added)

<u>The DCF Method.</u> Dr. Frisch submitted expert reports supplementing his audit report and further supporting respondent's determination. His opening trial report uses the same DCF method used in the notice of deficiency and is the most reliable method to value the bundle of intangibles transferred to AEHT in the restructuring. Amazon's own financial focus on long-term growth of free cash flow per share supports the reliability and appropriateness of the DCF method.[26] Amazon used a DCF method to value corporations it was considering acquiring. The restructuring transferred Amazon's entire European business. Valuing the bundle of intangibles together using a DCF is more reliable than attempting to identify and separately value the intangibles in the bundle because the intangibles operate

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[26] Ex. 1-J (1997 Letter to Shareholders). Amazon's 1997 Letter to Shareholders has been reprinted in every annual report issued since 1997. Exs. 1-J through 16-J, 280-J.

collectively maximizing the value and return on these intangibles. When it submitted its Transfer Pricing Study (which like Dr. Frisch, used an unspecified income method) Amazon implicitly admitted that none of the specified methods was likely to provide a reliable measure of an arm's length result. Amazon's own use of an unspecified method shows that the Service's method is not arbitrary, capricious or unreasonable.

A residual profit split method is not appropriate in this case because all the intangibles belonged to the Amazon U.S. Group prior to restructuring and AEHT had no assets or capabilities of its own. See Section 1.482-6(c)(3)(i)(B). The risk assumed by AEHT in making cost sharing payments beginning in 2005 is significantly less than the risk assumed by the Amazon U.S. Group when it developed the transferred intangibles. AEHT's forecasted IDCs would not generate premium residual profits without the buy-in intangibles. If the IDCs by themselves really were expected to attract premium profits, then Amazon would be better off operating the EU business and paying for intangible development itself than transferring it for a price that excluded such profits. See Section 1.482-1(f)(2)(ii)(A).

Dr. Paul Gompers, an economics professor at the Harvard Business School, explains why the DCF method is the most

reliable method to value Amazon's website intangibles and the method's widespread use in business. He reviewed Dr. Frisch's audit report and concluded that Dr. Frisch correctly applied the DCF method in this case. Professor Gompers further opined that Dr. Frisch's opinions on the appropriate discount and growth rates are conservative. Senior IRS Economist Forrest Oswald, who was the lead economist on audit, further supports Dr. Frisch's DCF method by analyzing the alternatives available to the Amazon U.S. Group: earning the projected income by keeping the IP, continuing the business and paying to develop intangibles itself or transferring the IP to an uncontrolled third party who would be willing to pay the present value of expected cash flows from the IP.

Respondent's economic experts show the relationship between the buy-in and projected IDCs, explaining that by using a discount rate of 18 percent, Dr. Frisch subtracts from his buy-in valuation an annual cash flow return of 18 percent on AEHT's investments, including its IDCs. The buy-in value determined by the DCF is the present value of cash flows in excess of the 18-percent return to AEHT's expected IDCs. Under Dr. Frisch's method, AEHT receives an 18-percent return on those costs plus any unanticipated returns. An uncontrolled party in AEHT's position would not expect a greater return because it was bringing nothing to the table other than cash. Before the

transfer, AEHT had no revenues or positive cash flows; on the day after the transfer became effective, AEHT was able to use all of the intangible assets and, as a result, had billions of dollars of revenues on an annual basis. Amazon U.S. bore the risk and deducted the expenses associated with creating the intangibles that generated those revenues and should receive the expected returns.

Expert Support for Respondent's Notice Determination. Dr. Higinbotham analyzed agreements between Amazon and third-party retailers who paid Amazon to develop websites for them under Amazon's Merchant.com program. He selected an agreement between Amazon and Target as the most comparable to use as a CUT to value the technology platform transferred to AEHT. He calculated an implied four-percent royalty rate in the Target contract and derived a value of $2.757 billion for the technology intangibles transferred to AEHT based on projected AEHT revenues less AEHT's anticipated IDCs.[27]

Investment banker Jim Timmins valued the intangibles used in Amazon's EU Websites Business by analyzing Amazon's stock price on the valuation date. He determined that an uncontrolled investor would value Amazon's European intangibles at $4.8 billion. Mr. Timmins' valuation corroborates the DCF buy-in

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[27] Dr. Higinbotham increased expected IDCs based on corrections he made to Amazon's method for identifying actual IDCs.

value as the arm's length result and is consistent with a market multiple method confirming analysis performed by Dr. Frisch.

Respondent's technology experts establish a significantly longer life for Amazon's technology than Deloitte (seven years) or petitioner's trial experts (six years or less). Based only on the replacement rate of software code, Dr. Cohen of Elysium Digital LLC determined that some of Amazon's code would be expected to and did last almost twelve years. Dr. Felten, from Princeton University, explained why other intangibles that were not analyzed or considered by petitioner's experts, such as patents, know-how, and trade secrets, also contribute to the value of the technology intangibles and would not necessarily be short-lived.[28]

David Haigh of Brand Finance, a U.K. brand valuation firm, valued the Amazon brand in Europe at approximately $1.167 billion. Brand is an aggregate of intangibles, including trademarks and their associated goodwill and domain names. Respondent's brand and technology expert Professor James Conley, from Northwestern University, shows that a properly managed IP portfolio is expected to accrue value to the brand and that

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[28] As Dr. Frisch explains in his opening trial report, less than $400 million of his total valuation is attributable to income after 2024. Instead, the most significant and by far the largest difference between the buy-in payments calculated by Dr. Frisch and petitioner's experts is attributable to petitioner's ramp down of Amazon's income projections.

petitioner's IP portfolio and brand would have been expected to increase in value over time. Dr. Ronald T. Wilcox, a marketing professor from the University of Virginia's Darden School of Business, demonstrates that the Amazon brand had an indefinite useful life and substantial value in Europe at the end of 2004. Amazon's strategy was to invest aggressively in its technology and business to expand and leverage its customer base, brand and infrastructure, to establish an enduring franchise. Professor Conley provides academic support for Amazon's marketing strategy: investments in shorter-lived technology assets enhance long-lived brand value that is expected to grow over time.

The Amazon U.S. Group Owned all European IP Pre-Restructuring. ACI subsidiaries, AIM and AIS, operated the EU Websites Business prior to the restructuring and licensed the necessary intangibles from ATI, another U.S. subsidiary. Before the Business Transfer Date, all of the income from the European business, including profits from intangibles, was reported by ACI. Afterwards, it was all reported by AEHT. Contemporaneous Amazon documents show that local operating subsidiaries had registered certain trademarks and domain names in their own names in their respective countries solely for administrative convenience to comply with foreign law requirements. The April

30, 2006 agreement assigning the registrations to AEHT provides a price of less than a million dollars.[29]

Petitioner now claims that these intangibles were owned in Europe so that AEHT is not required make a buy-in payment to petitioner for them and that their value was substantial (approximately 50 percent of petitioner's total revised $251-$312 million trademark valuation). The local operating subsidiaries who registered the trademarks and domain names were generally compensated for their routine activities on a cost plus basis and incurred little risk. As a matter of both economics and tax law, petitioner was the tax owner of the trademarks and domain names prior to the restructuring and is entitled to arm's length compensation for transferring them to AEHT. Section 1.482-4(f)(3)(i). Having developed the IP at its own expense and risk and reimbursed the operating subsidiaries for expenses of maintaining and enhancing the IP, petitioner's claim that the subsidiaries and not petitioner owned the rights to the income from the IP is inconsistent with economic substance and the parties' own conduct.

The facts and circumstances of the Amazon controlled parties' arrangement are that the EU Operating Subsidiaries registered and held the intangibles as agents or nominees of petitioner so that petitioner is the "legal owner" of the

[29] Ex. 229-J.

intangibles under section 1.482-4(f). Professor Jorge Contreras, an intellectual property law and practice expert, explains that when an uncontrolled local company registers a domain name or trademark because of restrictions forbidding a foreign company to do so, the parties will typically enter into an agreement pursuant to which the local company acts as an agent for the foreign owner.

Alternatively, if the operating subsidiaries, as registrants, are legal owners of these intangibles, respondent imputes an agreement whereby they granted a royalty-free perpetual and exclusive license to petitioner to develop and use the intangibles at its own risk and for its own benefit. Sections 1.482-4(f)(3)(ii), 1.482-1(d)(3)(ii)(B). That license entitled petitioner to all of the income from the IP less allocable service fees paid to the operating subsidiaries. Dr. Frisch's opening expert report and David Haigh's and Professor Hoeren's reports rebutting Professor Franklyn, explain the economic ownership of the European-registered IP and support an imputed license agreement. Petitioner is entitled to buy-in compensation for transferring that legal ownership interest in the intangibles to AEHT in the restructuring.

Petitioner's Case. Amazon has abandoned its tax return valuation of the EU websites' IP and changed the facts, assumptions and theories on which it was based. Amazon's

eighteen trial experts use new valuation methods, including a different best method. Executing trial counsel instructions, they assume that AEHT is an "entrepreneur" without explaining what that means, and value only a subset of transferred assets, excluding admittedly valuable intangible property that was used in the EU business and also the IP registered by the EU Operating Subsidiaries. They determine new lives and decay rates for the EU Websites assets, apply new discount rates, and calculate higher expected returns for the EU Operating Subsidiaries' functions. Amazon has discovered new operating expenses that its experts subtract in projecting European income and has recomputed the projected IDCs included in its valuation model.

Amazon fact and expert witnesses put forward new claims that Amazon's EU Websites Business at the end of 2004 were nascent, risky startups operating in risky countries and a risky business sector dominated by competing firms and that Amazon's technology platform was on the brink of collapse. The only bright spot according to Amazon was the activities of the local operating companies adapting Amazon's business model and technology to the U.K., Germany and France. The new litigation spin is contradicted by Amazon's public statements and internal documents about its expectations as well as market expectations about the company and the countries and markets in which its

European businesses were operating. On the January 1, 2005 valuation date, Amazon had been operating for seven years in Europe, rapidly growing revenues and market share by using the same business model, marketing strategies, e-commerce technology, product categories, data and trademarks and trade names that led to its success in the U.S. market. In fact, Amazon had a bigger market share in Europe than in the U.S. Its stock price reflected high expectations of investors.

Petitioner's unrealistically low values for the transferred intangibles are the product of counter-factual and legally baseless assumptions.[30] Counsel instructed petitioner's economic experts to value only "readily identifiable" intangible assets such as "patents, copyrights, trademarks, or software code" regardless of whether more "nebulous" intangible assets such as "growth options," goodwill or going concern value were transferred to AEHT.[31] Petitioner's experts were told to assume that European entities contributed intangibles, including trademarks, local goodwill and going concern and domain names. Petitioner's technology experts were asked to determine how long

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[30] Petitioner offers values for the transferred intangibles that are substantially higher than its return position. Dr. Wills' revised range is $420 to $560 million and Dr. Unni's revised range is $421 to $601. If the Court adopts petitioner's arguments regarding IP registered by its subsidiaries prior to the restructuring, Dr. Wills' range drops to $284 to $413 million and Dr. Unni's to $346 to $431 million.

[31] See Petitioner's Expert Report of Bradford Cornell, p. 14.

the technology platform would last "with just reasonable maintenance and absent continued innovation."[32] Petitioner's trademark expert estimated the period of time during which the transferred trademarks would continue to provide a premium economic return assuming no further development. None of petitioner's eighteen trial experts offers an opinion that ACI would transfer the intangibles it used in its EU Websites Business to an uncontrolled party for anything less than the present value of their anticipated cash flows.

The Project Goldcrest intercompany contracts expressly transfer the right to use Amazon's intangible property in future development activities to maintain, enhance or modify that property or use it as the basis for new property. Under the QCSA, AEHT gets 31 percent of the income generated by development. Amazon's success globally was attributable to continuous innovation of its e-commerce technology, marketing and brand building strategies in place on January 1, 2005 and it expected to continue to innovate after that date. Although AEHT received the right to use the transferred intangibles in future research and development, none of petitioner's trial experts determined the value of those rights. Rather, those rights were assumed to have no value -- at least no value that needed to be accounted for in the buy-in.

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[32] See Petitioner's Expert Report of David Parkes, p. 2.

Petitioner assumes that once intangible property was enhanced or improved rather than merely maintained, it no longer contributes to the projected revenues and income. Petitioner's experts ramp down the projected income streams in their valuations based on rapid decay rates and short useful lives. Petitioner attributes the difference between its values and that of the market to growth options that its expert assumes is "akin to goodwill," without any showing that the facts support such assumption.

Petitioner reads this Court's opinion in VERITAS as granting multinational taxpayers *carte blanche* to transfer valuable intangibles, including R&D rights, for free.[33] Petitioner's case is a list of "me-too" arguments: that the DCF cannot be used to determine a buy-in, that respondent erroneously used a business enterprise valuation, that respondent assumed intangibles had a perpetual useful life, that respondent failed to identify and value separate items of intangible property, that respondent improperly included income attributable to AEHT's ownership and development of covered intangibles, and that respondent applied methods in regulations effective in 2009.[34]

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[33] Petitioner's expert witness, Dr. Cornell, cited VERITAS in his expert report to help explain his understanding from counsel.
[34] Petition, ¶¶ 4.a., 5.a.41 through 5.a.48.

Transfer pricing, including selection of the best method, is inherently factual. Section 1.482-1(c)(1) and (2). In VERITAS, the Court found that (1) the technology transferred by the taxpayer had little or no value beyond the value of the current product line; (2) the products were continually made obsolete by technological advances in software and hardware; (3) the pre-existing technology had no ongoing R&D value and the value of technology developed under the QCSA was not attributable to pre-existing technology; and (4) marketing successes were due to a newly-hired sales manager and savvy marketing. The VERITAS Court's rejection of a DCF-like valuation in favor of CUT-based valuations of specific groups of intangibles on those facts says nothing about how this case should be decided. Well before the restructuring, Mr. Bezos described Amazon's e-commerce technology, brand power and fulfillment infrastructure as an e-commerce platform. Amazon transferred all of the cash flows from its EU Websites Business, including, therefore, all of the income from the intangibles comprising that platform. Respondent's DCF method values, in the aggregate, the bundle of intangibles that comprise the platform. Unlike the "shrink-wrapped" software products that VERITAS periodically updated, Amazon was continuously developing and improving its e-commerce technology and its brand for use in its e-commerce business. Petitioner's own trial experts valued

two aggregated groups of intangibles -- technology intangibles and marketing intangibles.

Petitioner's experts devote hundreds of pages attempting to estimate how long Amazon's software or trademarks would last without development, and to differentiate maintenance from improvement for different categories of intangibles as well as particular technologies. The arbitrary and counter-factual assumptions petitioner's experts are forced to employ, in what is plainly an exercise in futility, proves that in this case the DCF is the best method. Respondent's experts establish that the intangibles transferred to Europe have indefinite useful lives, the length of which is impossible to predict. The useful lives of the intangibles, and thus their values, are increasingly uncertain over time and as development of the intangibles continues. The DCF method is the most reliable way to account for that decline in value.

Respondent's technology and brand experts explain why the intangibles transferred in this case had continued value as a basis for the continuing process of innovation. Respondent's economic experts provide strong support for using the expected future income from covered intangibles to measure the value of the transferred IP. Pre-existing intangibles afforded more than a mere head start here, where the research and development involved continuous improvement and innovation of an e-commerce

platform and brand. At arm's length, the value of that head start in contributing, together with the ongoing IDCs, to the income from intangibles developed under the QCSA must be paid for with a buy-in. The expected value of the fruits of development, as measured by Amazon's own projections, must be attributable to either the pre-existing intangibles or the IDCs. Dr. Frisch's DCF method provides AEHT with an 18-percent return on AEHT's IDCs, a relatively high return for a startup. In contrast, petitioner's tax reporting position implies an expected return to AEHT of 128 percent.

Petitioner also rejects respondent's DCF on the grounds that it includes intangibles that petitioner admits are valuable in the market but contends can be transferred for free under section 482. Petitioner offers the Court no assistance in determining the value of what it claims are noncompensable growth options allegedly included in Dr. Frisch's DCF and does not explain why Dr. Frisch's DCF values more than pre-existing intangibles. Petitioner never explains why it makes sense to interpret sections 1.482-4(b) and 1.482-7A as allowing or even requiring transfers of certain intangibles to go uncompensated between related parties even though such transfers would clearly be compensated at arm's length.

Based on the Amazon projections used to evaluate Project Goldcrest, Dr. Frisch's DCF valuation of pre-existing

intangibles is supported by accepted economic theory as a reliable measure of what an uncontrolled party would pay for the bundle of intangibles Amazon made available to QCSA. Dr. Higinbotham's CUT-based technology valuation, Mr. Haigh's brand valuation and Mr. Timmins' market valuation all corroborate Dr. Frisch's DCF valuation. See section 1.482-1(c)(2)(iii). Any claim that some portion is attributable to intangible property that is not compensable is contrary to section 1.482-4(b) and the arm's length standard. Respondent was not arbitrary or capricious in allocating income to petitioner by increasing the reported buy-in based on petitioner's financial projections, including IDCs. Respondent's adjustment is necessary to reach an arm's length result.

Cost Pool Issue

Petitioner chose to enter into a QCSA on January 1, 2005, following a long and careful consideration of all of the tax issues involved in Project Goldcrest, but did not maintain contemporaneous records that tracked IDCs or that allowed it to readily identify IDCs. Section 1.482-7A(d)(1) requires participants in a QCSA to share "all of the costs" that are "related to the intangible development area."[35] The regulation

[35] "Costs incurred related to the intangible development area consist of ... operating expenses as defined in § 1.482-5(d)(3), other than depreciation or amortization expense, plus ... the charge for the use of any tangible property made available to

requires that all costs that relate to intangible development be included in the cost pool. "The regulations permit costs to be allocated only '[i]f a particular cost contributes to the intangible development area and other areas or other business activities.' Section 1.482-7A(d)(1)." Amazon v. Commissioner, T.C. Memo. 2014-149, at *9. If it is appropriate to apportion specific costs between the QCSA activity and other activities, such costs

> must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributed to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits.

Section 1.482-7A(d)(1).

Petitioner's anecdotal descriptions of various activities conducted in selected cost centers is insufficient to meet its burden. Petitioner has not articulated a basis or standard for distinguishing between T&C costs that are IDCs and T&C costs that are not or explained why the described activities are not IDCs. The costs that petitioner classifies under Technology and

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the qualified cost sharing arrangement." Section 1.482-7A(d)(1). See section 1.482-7A(j)(2)(i)(A)(requiring taxpayers to maintain documents necessary to establish the total amount of costs incurred in the arrangement); Ex. 53-J, § 5.3.(requiring cost sharing participants to maintain written records in sufficient detail to permit ready verification of the computation of Development Costs).

Content for financial purposes appear to be well within the broad scope of the Development Plan defined in petitioner's QCSA. Respondent did not abuse his discretion in determining that 100% of T&C costs are IDCs.

Even if petitioner is able to establish that some of its T&C cost centers contain costs that are not related to the Development Plan so that use of an allocation method is justified, the results of petitioner's two-ratio allocation method are per se unreasonable. Using this method, petitioner treated less than 50 percent of its U.S. and Canada Technology and Content financial statement costs as costs related to intangible development, a questionable result given the nature of those costs and the Development Plan.[36] Petitioner simply ignored these anomalous results quarter after quarter. It conducted no testing, sampling or quantitative assessment to verify that its allocation methodology captured all IDCs in the T&C cost centers. Petitioner's cost pool trial expert Dr. Roman Weil did not express an opinion on the reasonableness of petitioner's method. Dr. Higinbotham merely made improvements to petitioner's allocation method using the same R&E credit

[36] The percentage of costs included by petitioner as compared to Technology & Content costs is shown below:

Year	Q1	Q2	Q3	Q4
2005	33.3%	50.7%	48.2%	41.3%
2006	40.4%	43.0%	44.3%	42.5%

documents petitioner used that increased the cost pools. He lacked sufficient information to accurately identify all IDCs.

Buy-In and Cost Sharing Payments. In order to apply the DCF method to the valuation of Amazon's EU Website Business, Dr. Frisch made the reasonable assumption that AEHT would make ongoing investments related to maintaining, improving, enhancing, and extending the transferred pre-existing intangible assets jointly with Amazon under the cost sharing agreement, which would ensure continuation of Amazon's EU Websites Business operations going forward. The cash flows from intangibles that Dr. Frisch derived from Amazon's income projections are attributable to either the pre-existing intangibles or to projected IDCs. Thus, as projected IDCs and the return thereto increase, the value of the pre-existing intangibles and the return thereto necessarily decrease.[37] Increasing projected IDCs reduces the buy-in amount in Dr. Frisch's DCF valuation and also in Dr. Higinbotham's CUT-based income valuation. The projections prepared by Amazon Finance in connection with Project Goldcrest included projected IDCs based on Amazon's

[37] Dr. Frisch reduced Amazon's projections by AEHT's investment costs, including AEHT's cost sharing payments, to eliminate any value attributable to covered intangibles. By deducting future investment costs, the DCF values only pre-existing assets and provides a rate of return to AEHT equal to its cost of capital, 18 percent in Dr. Frisch's method.

operating plans. Dr. Frisch used those estimated IDCs in his buy-in valuation.

Petitioner's trial experts increase Amazon's projected IDCs by assuming they grow at the same rate as projected revenues. At the same time, however, petitioner seeks to minimize the amounts of petitioner's actual IDCs in 2005 and 2006 and therefore AEHT's cost sharing payments in connection with the cost pool issue. Dr. Frisch's opening expert report computes the buy-in amount under three scenarios: Amazon's original projected IDCs [redacted]; revised projections based on IDCs determined in the notice of deficiency [redacted]; and Dr. Higinbotham's calculations, which increase petitioner's revised IDCs by correcting flaws in petitioner's allocation method based on available information [redacted].[38] Because for a QCSA, the price that an uncontrolled buyer would pay for an interest in the covered intangibles is cost sharing payments plus buy-in payments for IP contributed by another participant, all costs must be shared and all intangible value must be accounted for in the buy-in to reach an arm's length result.

[38] Dr. Frisch also shows the impact of petitioner's increased operating expenses for the Irish data centers that petitioner asserts should be subtracted from its original projections.

Stock-Based Compensation Issue

Petitioner compensated employees with restricted stock units, a type of stock-based compensation. Section 1.482-7A(d)(2) requires controlled participants to include the cost of such SBC in the cost pools if that compensation is related to the development of covered intangibles. Petitioner's own QCSA also required it to share SBC. Petitioner included an allocated amount of RSUs in its cost pools in 2005 and 2006.

Petitioner asserted an affirmative claim to reduce its reported cost sharing payments by excluding SBC but has not mounted a direct legal challenge to section 1.482-7A(d)(2). In its petition, petitioner noted only that another taxpayer (Altera Corp. and Subs. v. Commissioner, Docket Nos. 6253-12 and 9963-12) has challenged the validity of section 1.482-7A(d)(2) and alleged that "respondent's inclusion" of SBC in the cost pool would be arbitrary, capricious and unreasonable if the regulation is held to be invalid in that case.

Petitioner did not plead that section 1.482-7A(d)(2) is invalid and confirmed in interrogatory responses that it did not so contend.[39] Accordingly, respondent doubts this issue is

[39] In response to interrogatories as to whether it contended that section 1.482-7A(d)(2) was invalid and as to the legal and factual basis if it did so contend, petitioner did not state that it contended that the regulation was invalid but explained that it petitioned the Court on this issue "to preserve its affirmative claim in the event that the Court invalidates the

properly before the Court. If the regulation is invalidated in another case, petitioner's own QCSA provides a purported remedy: an adjustment of previously shared SBC in the year a final court opinion is issued.[40] Even if petitioner had properly raised the validity of the regulation as an issue in this case and disclosed a factual and legal basis for its claim, a stipulation to be bound to the outcome of Altera would be unacceptable to respondent because it would indefinitely delay the resolution of this case. Altera is before the Court on cross-motions for partial summary judgment and involves other issues that are not yet set for trial so that a final decision in that case is almost necessarily years away.

EXPERT WITNESS REPORT ISSUE

Petitioner has informed respondent that it will seek to file revised expert reports for a number of its trial experts. Some of the revisions are substantive. All revisions to petitioner's opening expert reports should be in the form of *erratas* to the reports previously lodged and exchanged on June 6, 2014 and August 1, 2014, so that the rebuttal reports of respondent's experts can be fairly understood.

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regulation in the other case." Petitioner's May 30, 2014 Response to Interrogatories 20, 21 and 22.

[40] Ex. 53-J, §§ 3.3(b)(iii) and (iv).

STIPULATIONS

As of the filing of this trial memorandum, the parties have lodged the following stipulations: 1) Stipulation for Trial - Goldcrest Facts (lodged December 19, 2013); 2) Joint Stipulation for Trial - Chronological Facts (lodged May 23, 2014); 3) Stipulation for Trial - Chronological Facts Exhibits (lodged May 23, 2014);[41] 4) Amended Stipulation for Trial - Goldcrest Exhibits (lodged August 8, 2014);[42] 5) Stipulation for Trial - Exhibits (lodged August 8, 2014); 6) Stipulation for Trial - Goldcrest Transaction Steps Facts (lodged October 6, 2014); and, 7) Stipulation for Trial - Goldcrest Steps Exhibits and Supplemental Exhibits (lodged October 6, 2014).

The parties have exchanged additional proposed fact and exhibit stipulations relating to Project Goldcrest tax reporting in the U.S. and Luxembourg, financial information, technology, cost pools, and stock-based compensation. Petitioner last week proposed new stipulations titled "Data and Metrics."

On September 12, 2014, respondent filed a Motion for Order to Show Cause Why Proposed Facts and Evidence Should Not be Accepted as Established Pursuant to Rule 91(f) ("Motion to

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[41] The parties intend to lodge an amended Joint Stipulation for Trial - Chronological Facts and Stipulation for Trial - Chronological Facts Exhibits to renumber the exhibits to avoid duplicating exhibit numbers.
[42] The Amended Stipulation for Trial - Goldcrest Exhibits amended the Stipulation for Trial - Goldcrest Exhibit lodged on December 19, 2013.

Compel Stipulation") in response to petitioner's refusal to stipulate to documents that it designated as protected under the pre-trial protective order. On October 6, 2014, petitioner filed a response to respondent's motion and a related Motion for Protective Order pursuant to Rule 103. Respondent expects that petitioner will stipulate to the matters covered by the motion following the entry of a Protective Order by the Court.

On October 3, 2014, petitioner filed a "protective" Motion to Compel Stipulation with respect to stock-based compensation and what it refers to as its "Proposed Financial Stipulation" (which, as it states in its motion, is actually petitioner's expert witness Robert Wentland's opening report dated June 6, 2014). On October 7, 2014, respondent responded to petitioner's October 3, 2014 proposed stock-based compensation stipulation. Respondent believes that the parties should be able to reach agreement on the Proposed Financial Stipulation.[43]

PROTECTIVE ORDER

Respondent addresses Petitioner's October 6, 2014 motion for a protective order in a separate filing. Respondent objects to sealing the parties' trial memoranda and asks the Court to

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[43] Based on an October 10, 2014 telephone conference with the Court, respondent understands that the Motion to Compel Stipulation filed by petitioner on September 22, 2014 with respect to a cost pool stipulation and the Motion to Compel Production of Documents filed by respondent on September 16, 2014 relating to the cost pool documents will be denied.

direct petitioner to expeditiously identify any portions of the memoranda that require protection and provide justification for sealing of those portions.

WITNESSES

Respondent will call/may call the following witnesses. Respondent reserves the right to call rebuttal witnesses and any witness identified or called by petitioner.

Fact Witnesses

Jeffrey Bezos *(Amazon): Founder and Chief Executive Officer.* Mr. Bezos will testify about the history of Amazon; its mission to be become the Earth's most customer-centric company; Amazon's growth and success; expansion of product categories; its 3PS Business, on-line retail and other businesses and products; Amazon's e-commerce technology, brand and fulfillment infrastructure; the purpose and evaluation of Amazon's acquisitions, its expansion into the European market, and its European restructuring in 2004 through 2006; and the organization of Amazon's business, executive oversight, business planning and Project Goldcrest.

Jeffrey Blackburn *(Amazon): Senior Vice President Business Development.* Mr. Blackburn will testify concerning Amazon's initial public offering, its evaluation of partnerships and acquisitions; Amazon's use of the DCF methodology and the cost of capital estimate used in business planning; his role in

negotiating sponsored search agreements and in improving customer service in Europe; and the organization of Amazon's business, executive oversight, business planning and Project Goldcrest.

Eric Broussard *(Amazon): Vice President International Sales.* Mr. Broussard will testify about Project Goldcrest and Amazon's European restructuring during 2004 through 2006; Amazon's European third-party business arrangements, including use of Amazon's technology platform, operational capabilities, services, and retail expertise in third-party arrangements; marketing activities with respect to the European third-party business arrangements; and Amazon's product categories.

Robert Comfort *(Former Amazon Employee): Chief Tax Officer.* Mr. Comfort will testify about the tax planning of the European restructuring; the entities involved in the restructuring, the QCSA and the transfer of intangibles to AEHT; the establishment of AEHT as the European headquarters in Luxembourg; the Luxembourg tax ruling and related royalty arrangements and the anticipated tax savings from the restructuring; and his review of Deloitte's transfer pricing reports regarding the restructuring and Amazon's tax reporting of the transaction.

William Crowe *(Amazon): Finance Department.* Mr. Crowe will testify concerning the financial forecasts prepared with respect to Project Goldcrest.

Custodian of Records *(Amazon):* To the extent petitioner objects to documents produced by Amazon on the grounds of authentication or hearsay, respondent will call witnesses to show that the documents are authentic business records.

Custodian of Records *(Deloitte): To be identified by Deloitte.* This witness may be necessary to authenticate documents used by Deloitte to prepare transfer pricing reports for petitioner.

Richard Dalzell *(Former Amazon Employee)*: *Chief Information Officer*. Mr. Dalzell may testify about Amazon's technology platform at the time he was hired in 1997; the changes and updates made to Amazon's technology during his tenure (through 2007); Amazon's conversion of its monolithic software into service-oriented software; use of Amazon technology existing at the time of the restructuring to continue and improve its technology platform post-QCSA; and Amazon's technology relating to its supply chain and customer databases and the organization of Amazon's business, executive oversight, business planning, and Project Goldcrest.

Dave Fildes *(Amazon)*: *Finance Manager.* Mr. Fildes will testify regarding Amazon's financial forecasting models, including Amazon's country-specific valuation models and detailed cash flow projections.

Xavier Garambois *(Amazon)*: *Vice President of Retail* in Luxembourg. Mr. Garambois will testify about Amazon.fr, Project Goldcrest and Amazon's restructuring during 2004 through 2006; Amazon's use of "metrics" in its business; and the EU Websites Business, including use of petitioner's software technology in that business.

Kirk Geistfeld *(Amazon): Senior Tax Manager.* Mr. Geistfeld may testify regarding the preparation and filing of Amazon's 2006 Form 926.

Greg Greeley *(Amazon): Amazon U.S. Vice President EU Retail.* Mr. Greeley will testify as to Amazon's European operations, including the history of Amazon's European operations and his role in finance activities, including financial planning and evaluating acquisitions.

Scott Hayden *(Amazon): Vice President and Associate General Counsel of IP.* Mr. Hayden may testify regarding Amazon's intellectual property portfolio, including trademarks transferred to AEHT and Project Goldcrest, and regarding documents AMZCOM00141566 - AMZCOM00141568.

Jeffrey Holden *(Former Amazon Employee)*: *Senior Vice President Discovery Supply Chain.* Mr. Holden will testify concerning Amazon's expectations at the time of the QCSA, including Amazon's intent to continue developing and enhancing existing technology and Amazon's expected success; Amazon's

distribution and ordering systems; "Worldwide Discovery," i.e. browse, search and explore; and the organization of Amazon's business, executive oversight, business planning and Project Goldcrest.

Jason Kilar *(Former Amazon Employee): Vice President of Marketplace and Worldwide Application Software.* Mr. Kilar will testify concerning his roles at Amazon beginning in 1997, including in marketing and category launches and as Vice President of Marketplace and Sr. Vice President of Worldwide Application Software; development of Amazon's Marketplace program; in Amazon's visions and goals, as discussed with the Board; and the organization of Amazon's business, executive oversight, business planning and Project Goldcrest.

Jocelyn Krabbenschmidt *(Former Amazon Employee): International Tax.* Ms. Krabbenschmidt will testify regarding Project Goldcrest; discussions with the Luxembourg and Irish authorities; projections and valuation models that petitioner and Deloitte used to evaluate Project Goldcrest and compute its reported buy-in; petitioner's tax reporting; and computation of cost sharing payments.

Anne Krook *(Former Amazon Employee): Various positions.* Ms. Krook may testify concerning the development of the "look and feel" of the Amazon.com site from 1997 through 2010; guidelines used to add content and new features; technology and

development tools used in the industry before and after the restructuring; customization of the platform to accommodate third party licensees; planning and implementation of Project Goldcrest; Amazon's EU operations prior to the QCSA; and the steps that Amazon takes to market its brand.

Charles Moore *(Amazon): Vice President of Kindle.* Mr. Moore will testify regarding Merchants.com agreements entered into by Amazon during 2005 through 2010; Amazon's 3PS Business; and Amazon management's vision and goals at the time of the restructuring.

Dana Northcott *(Amazon): Senior Corporate Counsel, IP.* Ms. Northcott may testify regarding Amazon's intellectual property and the value and tiered structure of Amazon trademarks and domain names transferred to AEHT.

Doug Odell *(Internal Revenue Service): International Examiner.* Mr. Odell may testify regarding information provided by petitioner to the Internal Revenue Service during the audit, petitioner's cost sharing model and regarding summaries.

Brian Olsavsky *(Amazon): Vice President of Finance, Global Consumer Business.* Mr. Olsavsky may testify regarding the financial impact of Project Goldcrest; Amazon's financial planning processes and budgeting systems; Amazon's cost center structure; Amazon's financial forecasting process as it relates

to new projects and launches; and Finance's role in Amazon's overall growth strategy prior to, and after, the restructuring.

Forrest Oswald *(Internal Revenue Service): Senior Economist*. Mr. Oswald may testify regarding information provided by petitioner to the Internal Revenue Service during the audit.

Diego Piacentini *(Amazon): Senior Vice President, International Consumer Business*. Mr. Piacentini will testify regarding Amazon's online marketing and merchandising strategy for the U.S. and European markets; Amazon's European market share; implementation of Amazon's technology locally (for European markets); launch of product categories and features in Europe; his role in Project Goldcrest; Project Goldcrest's impact on the European business; metrics used to evaluate Amazon's business; development and protection of the Amazon brand; and the organization of Amazon's business, executive oversight and business planning.

Keith Reams *(Deloitte): Global and US Leader for Clients and Markets - Transfer Pricing*. Mr. Reams may testify regarding the transfer pricing studies he prepared and related documents in connection with petitioner's Project Goldcrest restructuring and to authenticate documents.

Tom Szkutak *(Amazon): Chief Financial Officer*. Mr. Szkutak will testify regarding Amazon's general financial structure and

condition in and around 2004; his role in Project Goldcrest; the purpose, planning and implementation of Project Goldcrest; the impact of Project Goldcrest on Amazon's European business; Amazon's financial forecasting; use of financial metrics, evaluation of possible acquisitions, product and feature launches; Amazon's investment in e-reader (Kindle) technology; Amazon's expectations about its growth in and around 2004; the organization of Amazon's business, executive oversight and business planning; and Amazon's representations to investors and analysts.

Brian Valentine *(former Amazon): Senior Vice President, Platform Technology.* Mr. Valentine is scheduled to testify at a special trial session commencing October 24, 2014. Respondent may call him to testify about Amazon's platform technology if petitioner does not.

Navid Veiseh *(Amazon): Director Product Development, Fulfillment by Amazon.* Mr. Veiseh may testify regarding Amazon's financial forecasting models.

Allan Vermeulen *(Amazon): Distinguished Engineer.* Mr. Vermeulen will testify regarding the transition from Obidos to Gurupa; the challenges Amazon faced in terms of scale and storage issues; Amazon's approach to software development; the concept of technical debt; how software was tested and rolled

out, including in Europe; and the development and use of Brazil and Apollo software.

Werner Vogels *(Amazon): Chief Technology Officer.* Mr. Vogels may testify regarding the development of software to address Amazon's scale issues; the development and evolution of AWS; technology storage issues and solutions; technology developed to support third-party sellers and Merchants.com; technology developed to support fulfillment services; and changes in Amazon's platform technology from 2004 to the present.

Peter Vosshall *(Amazon): Vice President & Distinguished Engineer.* Mr. Vosshall will testify regarding the change in Amazon's technology platform from a monolithic architecture to a service-oriented architecture; Amazon's technology storage solutions; the development of Amazon's Customer Master Service; and "best" software development practices utilized at Amazon.

Andrew Weinstein *(Former Amazon Employee): Tax Director, Audits & Acquisitions.* Mr. Weinstein may testify regarding information provided by petitioner to the Internal Revenue Service during the audit.

Jeffrey Wilke *(Amazon): Senior Vice President Consumer Business Operations.* Mr. Wilke will testify about Amazon's worldwide operations, fulfillment and supply chain technology prior to, and after, the restructuring. He will also testify

concerning the organization of Amazon's business, executive oversight, business planning and Project Goldcrest.

Expert Witnesses

Dr. Geoff A. Cohen, a Ph.D. with Elysium Digital, LLC, will testify regarding the engineering, development, value and life of petitioner's intangible property, particularly software code, including that Amazon's code would be expected to and did last significantly longer than the useful life estimated by Deloitte and petitioner's experts, that petitioner's experts rely on inaccurate assumptions and use inappropriate metrics to measure the useful life of Amazon's software code, and that key components and portions of source code from 2005 are still part of Amazon's platform today.

Dr. James G. Conley, a marketing professor at the Kellogg School of Management at Northwestern University with expertise in technology and brand, will testify regarding the creation, development and valuation of petitioner's intangible property; that the value generated by IP assets with a limited life can be "transferred" to other IP assets with longer indefinite lives and that this transference has the potential to enhance the value of brand, that it was reasonably foreseeable that the intangibles transferred to AEHT would appreciate in value, that in fact, the value of the intangibles increased over time; and

that petitioner's ramp down curves do not capture the full value attributable to the IP transferred to AEHT.

Professor Jorge Luis Contreras, currently an intellectual property law professor at the University of Utah and formerly a practicing attorney in the field, will testify regarding intellectual property law and industry practice with respect to intellectual property agreements, including the legal rights and legal protection for different types of property, and the terms that would be negotiated at arm's length for registration of local trademarks and domain names; and that the methodology devised by petitioner's expert for allocating a portion of the value of trademarks and domain names to the EU Operating Subsidiaries is flawed.

Dr. Edward W. Felten, the Director, Center for Information Technology Policy, and Robert E. Kahn Professor of Computer Science and Public Affairs at Princeton University, will testify regarding the engineering, development and valuation of petitioner's intangible property and software industry practices generally; that the value of patents, know-how, and customer information also contribute to the value of the intangible property transferred to AEHT; and that petitioner underestimates the useful life of the technology IP transferred to AEHT.

Dr. Daniel J. Frisch, Managing Director, Horst Frisch Incorporated, Harvard Ph.D. economist and transfer pricing

expert, will testify regarding the arm's length price of the intangible property transferred by petitioner in the restructuring; the arm's length return on the development costs shared by petitioner and AEHT; and why the DCF is the best method to value the IP in this case.

Dr. Paul A. Gompers, a Ph.D. economist at the Harvard University Graduate School of Business Administration, will testify regarding business economics, entrepreneurial finance and valuation methodologies as applied to petitioner's intangible property; that Dr. Frisch correctly applied the DCF and that Dr. Frisch's opinions on the appropriate discount and growth rates are conservative; that the DCF is the most reliable method to value the intangible property in this case; and that it is improper to exclude benefits AEHT expected to receive from its participation in the QCSA.

Mr. David Haigh, a principal of Brand Finance, a U.K. brand consultancy firm, will testify regarding the definition of brand, and the fair market value of petitioner's brand in the EU at the time of the transfer, including the indefinite useful economic life of petitioner's brand.

Professor Thomas Hoeren, a foreign intellectual property law professor at the University of Munster, will testify in rebuttal to petitioner's expert Mr. Franklyn.

Dr. Harlow Higinbotham, a Ph.D. economist and transfer pricing expert, will testify regarding the arm's length price of the technology intangibles determined using a CUT method based on Amazon's 2001 agreement with Target and the costs related to intangible development covered by the QCSA.

Mr. Forrest Oswald, a Senior IRS economist, will testify regarding transfer pricing and the arm's length price of IP transferred to AEHT in connection with the restructuring of Amazon's EU Websites Business and that the DCF method is the most reliable method to determine the arm's length price for that property.

Mr. Jim Timmins, an investment banker and valuation analyst, will testify regarding the valuation of intangible property in business transactions, including industry practice with respect to the valuation and transfer of intangible property, and the valuation of petitioner's intangible property.

Dr. Ronald T. Wilcox, a Ph.D. and marketing professor at the University of Virginia's Darden School of Business, will testify regarding marketing, branding, customer intangibles and the creation, development and valuation of petitioner's brand and customer information; that Amazon's brand represented a significant ongoing source of value for Amazon that would outlive the technology embodied in the IP transferred to AEHT;

and that it is implausible to conclude that a brand as strong as Amazon would lose its value as asserted by petitioner.

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Date: 10-14-14 By:

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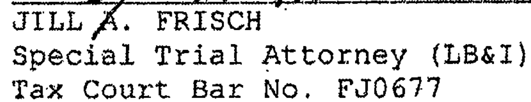
Docket No. 31197-12

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing RESPONDENT'S TRIAL MEMORANDUM was served on counsel for petitioner by delivering the same by electronic mail and private delivery service on 10-14-14 addressed as follows:

John Magee
Bingham McCutchen, LLP
2020 K Street, N.W.
Washington, D.C. 20006-1806

Date: 10-14-14



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