COST SHARING PAYMENTS –

ADJUSTMENT:

	FYE 2005	FYE 2006
Issue 1:		
PER RETURN:	$116,092,584	$ 77,297,000
PER EXAM:	$139,124,602	$187,186,346
ADJUSTMENT:	**$ 23,032,018**	**$109,889,346**

NOTE: These adjustments reflect the amounts after applying the RAB share for each year. The adjustments increase taxable income.

Issue 2:		
PER INFORMAL CLAIM	$ 59,752,000	N/A
AMOUNT OF CLAIM DISALLOWED	$ 59,752,000	N/A
ADJUSTMENT	**$ -0-**	**N/A**

ISSUE:

1. Whether Amazon.com, Inc. (the consolidated entity for U.S. income tax, here forth "Amazon US") properly included all intangible development costs in the cost share pools for tax years 2005 and 2006. Consequently, were the cost sharing payments recognized in 2005 and 2006 arms-length amounts?

2. Whether the taxpayer's informal claim filed on February 25, 2010, should be allowed to reduce the 2005 cost sharing payment. The taxpayer's informal claim requests an adjustment based on a reduction to cost sharing pools as a result of applying a QRE percentage and developer percentage to included Marketing and Technology & Content cost centers.

FACTS:

Amazon is a Delaware corporation with its principal offices located in Seattle, WA. Together with its subsidiaries, Amazon operates retail websites and offers programs for third parties to sell products on its websites. Amazon was founded in 1994 and opened its first website in July 1995. The company went public with an initial public offering in May 1997. As of FYE 2006, Amazon operated the following retail websites: www.amazon.com, www.amazon.ca, www.amazon.de, www.amazon.fr, www.amazon.co.jp, www.amazon.co.uk, www.joyo.com, www.shopbop.com, and www.endless.com. Amazon sells a broad range of products to its customers across a vast number of product categories. In addition, Amazon operates non-retail websites, including www.imdb.com, a movie database website as well as www.a9.com and www.alexa.com, which provide search and navigation capabilities to customers.

European Restructure
Beginning in FYE 2004 and continuing through FYE 2005 and FYE 2006 Amazon restructured the ownership of its European retail and services businesses ("EU website businesses"). The European website businesses consist of the operations relating to the websites www.amazon.co.uk, www.amazon.de, and www.amazon.fr ("EU websites"). Prior to the restructuring, the EU website businesses were operated by Amazon.com Int'l Sales, Inc. ("AIS") and Amazon.com Int'l Marketplace, Inc. ("AIM"), two wholly-owned U.S. subsidiaries of Amazon. AIS operated the EU retail website business and AIM operated the EU services business. AIS and AIM did not own any of the intellectual property (IP) related to the EU website businesses, as that was owned by Amazon Technologies, Inc. (Amazon Tech) and A9, Inc. (A9). AIS and AIM licensed the IP from Amazon Tech and A9 (U.S. subsidiaries) and utilized various wholly-owned foreign subsidiaries located in the UK, France, and Germany for certain marketing support, customer support and fulfillment services ("service affiliates"). AIS, AIM, Amazon Tech and A9 are all domestic subsidiaries consolidate/included in the U.S. Corporation Income Tax Return (Form 1120).

The stated goal for the restructuring was to relocate and centralize the operations of the EU website businesses in Europe. As a part of the European restructuring, Amazon formed newly created entities in Luxembourg to (a) hold the rights to the intellectual property needed to carryout the European website business, (2) operate the European website business and (3) transfer ownership of the service affiliates to the European operating entity. Amazon Europe Holding Technologies SCS (AEHT), a Luxembourg CFC for U.S. tax purposes by virtue of a check-the-box election[1] (a pass-through entity for purposes of local Luxembourg law) was formed to hold the Amazon IP. Amazon EU SARL (AEU), a taxable Luxembourg entity by local law (a disregarded entity of AEHT), is the European operating entity formed to carry out the EU website businesses previously carried out by AIS and AIM. After the restructure, AEHT licenses the Amazon IP to AEU.

On January 1, 2005, AEHT entered into a Qualified Cost Sharing Arrangement (QCSA) with Amazon Tech and A9. The January 1, 2005, QCSA included 3 agreements: (a)

[1] Amazon Europe Holding Technologies SCS (AEHT) is a partnership formed in Luxembourg and is treated as a pass-through entity for purposes of local Luxembourg law. The partners are ACI Holdings Limited (Gibraltar – 99.6%), Amazon.com, Inc. (Delaware - .3%) and Amazon Europe Holding, Inc. (Delaware - .1%)

LICENSE AGREEMENT FOR PREEXISTING IP between AEHT and Amazon Tech, (b) an *ASSIGNMENT AGREEMENT FOR PREEXISTING IP* between AEHT and Amazon Tech, and (c) an *AMENDED AND RESTATED AGREEMENT TO SHARE COSTS AND RISKS OF INTANGIBLE DEVELOPMENT* between AEHT and Amazon Tech & A9. The Agreement to Share Cost and the License Agreement were effective on January 1, 2005, however, the Assignment Agreement was not effective until April 30, 2006.

Although, as part of the QCSA, Amazon entered into the 3 agreements on January 1, 2005, the transfer of the business to Amazon EHT was not completed until April 30, 2006. The intent of the License Agreement was to transfer some, but not all, of the preexisting intangibles on January 1, 2005, and the intent of the Assignment Agreement was to transfer the remaining preexisting intangibles at a later date (ultimately, April 30, 2006, the "business transfer date"). Although AEHT started cost sharing January 1, 2005, during the interim period between January 1, 2005 and April 29, 2006, AIS and AIM continued to operate the EU website businesses. On April 30, 2006, AEHT and AEU commenced operations of the EU website business. (As of April 30, 2006, EU website business revenues were recognized offshore by AEU.)

After the restructuring was completed, AEU, a subsidiary of AEHT and disregarded for US tax purposes, became the operating entity of the EU website businesses and operated the business. AEHT received royalties from AEU for sublicensing the rights to the Amazon IP necessary to operate the EU website business. AEU then contracted with the European service affiliates in Germany, France, and the UK to provide various marketing support, customer support, and fulfillment services, just as AIM and AIS had done before the restructuring. All of Amazon EHT's European subsidiaries (including AEU and the service affiliates) are disregarded for US tax purposes.

Cost Sharing Agreement (CSA)

On June 7th, 2004, A9 and AEHT entered into an *AGREEMENT TO SHARE COSTS AND RISKS OF INTANGIBLE DEVELOPMENT* intending that the agreement constitute a qualified cost sharing arrangement under Treasury Regulation 1.482-7. The agreement's intent was to share the costs and risk of developing and using A9 Intellectual Property and grant AEHT a license to the A9 IP effective as of June 7, 2004. Amazon recognized cost sharing payments totaling $2,810,440 on their Form 1120 for tax year 2004 and no royalty (or buy-in) with respect to this agreement.

As mentioned above, effective January 1, 2005 AEHT entered into an AMENDED AND RESTATED AGREEMENT TO SHARE COSTS AND RISKS OF INTANGIBLE DEVELOPMENT) with Amazon Tech and A9. This agreement served to amend a prior agreement entered into by AEHT. The main purpose of the amended agreement was to add Amazon Tech as a party to the agreement to share costs and to restate the prior agreement to be effective January 1, 2005. The intent, per the agreement, is for the agreement to be a "qualified cost sharing agreement' as defined by Treasury Regulation 1.482-7.

The "Development Costs" to be shared under the agreement are defined in Section 3.1, which states development costs include all costs incurred by a party from activities relating to the "Development Program".

Section 3.3 (a) further defines "Included Costs" to include all direct and indirect costs incurred for activities performed pursuant to the "Development Program".

The scope of the "Development program" is discussed in Section 2 of the agreement. It states "the parties agree that all research, development, marketing and other activities relating to the Licensed Purpose are included within the scope of the Development Program. Such activities may include, but are not limited to, all development activities related to maintaining, improving, enhancing, or extending the Amazon Intellectual Property, A9 Intellectual Property and EHT Intellectual Property".

Taxpayer Cost Sharing Computations
The taxpayer computes the cost sharing payments quarterly. The quarterly cost sharing payments are calculated based upon input to a sophisticated excel spreadsheet model. Operating expenses for all cost centers by general ledger account are pulled from financial systems using Hyperion Essbase for actual financial data and Cognos for forecasted financial data.

The taxpayer's method for computing cost sharing payments in tax year 2005 differed from that in 2006.

2005 Cost Sharing Computations
The first step taken for determining which costs were to be included in the cost sharing pools for tax year 2005 was an evaluation of the cost centers to determine whether they should be "included' or "excluded" from the cost sharing computation. This was done by reviewing the cost center names for each of the numerous cost centers which roll up to the following top level (roll up) cost center categories:
Technology & Content C200 (Summary Roll-up for GAAP financial statements[2])
- Product Development C210
- Technology C250

[2] U.S. Generally Accepted Accounting Principles financial statements.

Marketing C150 (Summary Roll-up for GAAP financial statements)
- Business Dev C160
- Marketing C170

For "Product Development" cost centers, if a cost center was designated as "included", a "Developer Ratio" was applied to the cost center's costs. The "Developer Ratio" was based upon the ratio of the number employees with developer codes in their employee numbers to that respective cost center's total headcount. For example, if a cost center had 25 developers and total headcount of 100, 25% (25/100) of that cost center's costs would be included in the cost sharing pool. Employees were considered developers when they had a "T" designation included in their employee number. Amazon's Human Resources Department is responsible for determining such designations.

In 2005, both "Technology" and "Marketing" cost centers were determined to be included or excluded. If included, 100% of the costs were included in the cost sharing pool. There was no discounting based upon "Developer Ratio's". If excluded, no costs were included.

General ledger account names were reviewed to determine if costs captured should be included in the cost sharing pool. General ledger accounts determined to be included by the taxpayer were those determined to capture either direct or indirect costs associated with development activities. The taxpayer excluded certain general ledger accounts regardless of whether the cost center the account was charge supported the Development Program.

<u>2006 Cost Sharing Computations</u>
In 2006, the taxpayer introduced new concepts to the cost sharing computations. Unlike in 2005, all Tech & Content and Marketing cost centers were designated "included". However, the final includable portion was reduced by both a Developer Ratio and a new "QRE percentage". First the "Developer Ratio" was calculated for a particular cost center (developers/total headcount), as was done for 2005. This percentage is then multiplied by another ratio called the "Adjusted Qualified Research & Experimentation Time Spent" ratio. This ratio represents the qualified research and experimentation percentage (QRE%) for each cost center as determined by the taxpayer's R&D Credit study (a study performed for purposes of determining the Research & Development Credit under IRC § 41). However, the taxpayer makes some minor adjustments to the QRE percentages as follows. For the cost centers that have no QRE percentage, and are a part of Product Development C210 and Technology C250, the taxpayer would use the average QRE% for the respective category. These two cost center roll-ups (C210 and C250) are referred to as the R&D cost centers in the

taxpayers cost sharing models. The total cost for all the cost centers that roll-up to Development and Technology (C210 & C250) is disclosed as "Technology & Content" in the taxpayer's GAAP financial statements as reported in their U.S. Security and Exchange Commission 2005 and 2006 Form 10K.

To illustrate, assume a particular cost center has 100 employees and 40 are considered developers based upon job codes and or employee number. Further assume, based upon the taxpayer's § 41 R&E tax credit support, that 25% of the total costs spent in this cost center were qualifying research expenditures (QRE's). The total percentage of a cost center's costs included in the cost sharing pool would be 10%. (40/100 x 25% = 10%).

General ledger accounts are included or excluded as was done in tax year 2005.

Tax Return Amounts
On their 2005 Form 1120, Amazon recognized 2005 cost sharing payments totaling $116,092,584.[3] Amazon computed 2005 cost sharing payments totaling $118,595,000 (rounded). Amazon recognized $821,266 on their 2006 Form 1120. The intangible development costs included in the 2005 cost sharing pool totaled $373,244,706. Amazon computes its cost share payment and reasonably anticipated benefits (RAB) share on a quarterly basis. The average RAB share for 2005 is 31.1%.

On their 2006 Form 1120, Amazon recognized 2006 cost sharing payments totaling $77,297,000[4]. Amazon computed 2006 cost sharing payments totaling $84,193,000 (rounded). However, Amazon recognized $6,896,000 on their 2007 Form 1120. The intangible development costs included in the 2006 cost sharing pool totaled $260,844,008. Amazon computes its cost share payment and reasonably anticipated benefits (RAB) share on a quarterly basis. The average RAB share for 2006 is 32.3%.

LAW:

Internal Revenue Code (IRC) Section 482 provides as follows:
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of

[3] Response to IDR I-04.
[4] Response to IDR I-18.

taxes or to clearly reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The section 482 regulations apply an arm's length standard to dealings between controlled taxpayers. Treas. Reg. §1.482-7 provides guidance on qualified cost sharing arrangements between two or more parties.

Treas.Reg.§1.482-7(a)(1) states in part:
"A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of Treas.Reg.§1.482-1(d)(3)(ii)(B) (Identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement of this section."

Treas.Reg.§1.482-7(b) describes the requirements for a qualified cost sharing agreement (CSA) and states in part "A qualified cost sharing arrangement must--

(1) Include two or more participants;

(2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

(3) Provide for adjustment to the controlled participant's shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement..."

Treas.Reg.§1.482-7(d) describes the costs of developing intangibles that must be shared by the CSA controlled participants and states in part:
"...a controlled participant's cost of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants,

minus all of the cost sharing payments it receives from other controlled or uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in Treas.Reg.§1.482-5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in Treas.Reg.§1.482-5(d)(3)) the charge for the use of any intangible property made available to the qualified cost sharing arrangement."

Operating expenses as defined by Treas.Reg.§1.482-5(d)(3) include all expenses not included in cost of goods sold except for interest expense, foreign income taxes, domestic income taxes, and any other expenses not related to the operating of the relevant business activity. Treas.Reg.§1.482-5(d)(3) also states "Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.

Treas.Reg.§1.482-4(b) defines an intangible and states:
"For purposes of section 482, an intangible is an 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. 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.

Treas.Reg.§1.482-7(e) and (f) describe the term reasonably anticipated benefits or RAB and how each controlled participant's share of RABs is used to determine its share of intangible development costs (IDCs) or cost sharing pools.

Treas. Reg.§1.482-7(e)(1) defines benefits as "additional income generated or costs saved by the use of covered intangibles."

Treas. Reg.§1.482-7(e)(2) defines a controlled taxpayer's reasonably anticipated benefits (RAB) as "the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles."

Treas.Reg.§1.482-7(b)(4)(iv) defines a covered intangible as "any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area)."

A controlled participant's share of intangible development costs is determined under Treas.Reg.§1.482-7(f)(2) and states in part:
"A controlled participant's share of intangible development costs for a taxable year is equal to its intangible development costs for the taxable year (as defined in paragraph (d) of this section), divided by the sum of the intangible development costs for the taxable year (as defined in paragraph (d) of this section) of all the controlled participants."

Treas.Reg.§1.482-7(f)(3) goes on to state in part:
"A controlled participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits (as defined in paragraph (e)(2) of this section), divided by the sum of the reasonably anticipated benefits (as defined in paragraph (e)(2) of this section) of all the controlled participants. The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonable anticipated benefits.

GOVERNMENT'S POSITION:

1. It is the Government's position that the taxpayer improperly excluded costs from the cost sharing pools. Consequently, the cost sharing payments from AEHT recognized by Amazon US in tax years 2005 and 2006 were understated and not arms length.

2. It is the Government's position that the taxpayer's method of reducing included cost centers amounts by applying a QRE Percentage and a Developer Percentage is not proper. Therefore the February 25, 2010, informal claim to reduce the cost sharing payments recognized in 2005 is not allowed.

Development Program Costs
As stated above, Treas.Reg.§1.482-7(d) requires that the costs of developing intangibles that must be shared by the CSA controlled participants include all of the costs incurred by that participant related to the intangible development area (IDA). The regulation specifically excludes depreciation, amortization, interest expense, foreign

income taxes and domestic income taxes. The stated exclusions imply that **all costs** (other than those excluded) that are related to the IDA shall be included in the cost sharing pool. The regulation also requires that IDCs include a charge for the use of any tangible property. (The taxpayer's methodology estimates this charge by including relevant depreciation. Due to reasonableness and materiality factors, the government does not take issue with this method and accepts the taxpayer's method of estimating such charges for tax years 2005 and 2006. However, an adjustment is made for the taxpayer's inadvertent exclusion of a similar charge for the 1st quarter of 2005.)

Section 1.9 of the Agreement defines "Development Costs" as the costs incurred pursuant to Section 3 (Agreement) related to the performance of activities by a Party under the Development Program, including, but not limited to any and all costs incurred by a Party in the course of developing Derivative Works .

Section 1.10 of the Agreement states the "Development Program" means the activities of a Party within the scope and principles set forth under section 2 (of the Agreement).

Section 2.1 of the Agreement states "that all research, marketing and other activities relating to the License Purpose, after the effective date, are included within the scope of the Development Program. Such activities may include, but are not limited to, all development activities related to maintaining, improving, enhancing or extending the Amazon Intellectual Property, A9 Intellectual Property, and EHT Intellectual Property. ***All such activities shall be included in the Development Program except to the extent specifically excluded by mutual, written agreement of the Parties.*** " There was no written agreement excluding any activities from the Development Program.

Section 2.2 of the agreement provides: "The parties shall, from time to time, memorialize any new or acquired intellectual properties that are excluded from the Development Program by amending Exhibit A to this agreement." (Note: Exhibit A specified which intellectual properties were excluded from the Development Program. None were specified.)

Section 3.3 of the "Amended and Restated Agreement to Share Costs And Risks of Intangible Development" ("Agreement") also requires that all direct and indirect costs incurred by the Party during the term for activities performed pursuant to the Development Program, including allocable cost of general corporate overhead and administration, as **determined in accordance with United States generally accepted accounting principles (GAAP)** provided, however, that such direct and indirect costs shall exclude any depreciation or amortization incurred by a Party but include a charge for the use of any tangible property. The Agreement excludes only costs related to (a) corporate mergers and acquisitions and (b) registration or maintenance of World Wide Web domain names. The costs to be included per the Agreement are consistent with the requirements of Treas. Reg. section 1.482-7(d).

The "Agreement" also states that Amazon Intellectual Property, A9 Intellectual Property, and EHT Intellectual Property generally include any and all intellectual property rights throughout the world owned or otherwise held by Amazon, A9 and EHT, respectively, including technology and marketing based intellectual property. The only excluded intellectual property was any of Amazon's World Wide Web domain names (see sections1.1, 1.4 and 1.11).

Section 1.13 of the Agreement generally provides that the Licensed Purpose is for the right to use of Amazon and A9 Intellectual property to carry on the Amazon website business in Europe. The Licensed Purpose appears to include all aspects and lines of Amazon's businesses, as there are no excluded businesses, activities or purposes.

Sections 6.1 and 6.2 of the Agreement describe the A9 and Amazon IP rights granted to AEHT. The provisions do not specifically exclude any rights to A9 or Amazon IP.

It is the Government's position that the Development Program includes all research & development and marketing activities which are support of IP that benefits Amazon's global business. The Development Program would not include any activity that is supportive of IP that is specific to only a certain geographic market because an arms length party would not agree to share cost of developing IP that does not benefit their business. Also, the Development Program would not include any functions or activities which are considered routine (such as sales and distribution activities) and not supportive of IP.

It is the Government's position the taxpayer improperly excluded costs form the pool of costs required to be shared ("IDC cost pool"). The taxpayer's method of determining costs that are included in the IDC cost pool are contrary to both Treas. Reg. section 1.482-7(d) and the taxpayer's own Agreement. In addition, the taxpayer's method of determining included costs is not based on sound economic, financial or generally accepted accounting principals. The Government's position is that all costs that support an activity or function that supports the Development Program are to be included in the cost pool. The taxpayer excluded costs from costs centers supporting the IDA without showing that such costs were not relevant; such as costs that (1) supported routine functions/activities or (2) supported IP that was specific to a geographical market outside the cost sharing participant's territory.

Cost Centers
The taxpayer's internal books of account are organized by cost centers that relate to certain activities or functions. These cost centers roll up to a more general activities or functions (summary roll-ups) that are reported on their Annual Reports (U.S. S.E.C. Form 10-K). The activities or functions reported on the taxpayer's Annual Reports are:

a. Cost of Sales
b. Fulfillment
c. Marketing
d. Technology and Content (Tech & Content)
e. General and Administrative (G&A)

The taxpayer's cost centers are specifically numbered, named and categorized under one of the above activities. All costs are accounted for in one of the above activities. Accounting principles require that all cost centers that roll up to one of the above activities support that activity. Accounting principles require that all costs charged to a cost center, regardless of how classified as a general ledger account, are supportive of that cost center charged and therefore supportive of that activity's summary roll-up.

Two of the aforementioned activities (Marketing and Tech & Content) directly support the development of the taxpayer's IP and one of the aforementioned activities (G&A) indirectly supports the development of the taxpayer's IP. Therefore, Marketing, Tech & Content and G&A activities should generally be included in the Development Program as required by the Agreement. The cost centers that roll up to Marketing and Tech & Content should be included in the IDC cost pools unless it can be shown that the cost center is actually supportive of a routine function (not supportive of IP) or is supportive of IP that is specific to a geographic market outside the foreign participants territory (and does not benefit the foreign participant's business)[5].

It is the Government's position that all of the taxpayer's cost centers must be supportive of an activity that is either COGS[6] related, routine or non-routine (intangible development). If a Marketing cost center or a Tech & Content cost center is not supportive of IP, then it must be supportive of a routine function or activity. Such routine function or activity must be identifiable. If a Marketing or Tech & Content cost center is not supportive of a routine function or activity, then it is supportive of IP and thus should be included in the cost pools. Marketing and Tech & Content cost centers that are

[5] For example, a marketing program that is directed specifically at customers in the U.S. which does not enhance the marketing intangibles outside the U.S. generally would not add value or benefit the European business.
[6] Cost of Goods Sold

supportive of IP can only be excluded if the IP supportive is specifically excluded by the Agreement. With respect to the Agreement, the only activities and costs excluded were those related to (a) mergers & acquisitions and (b) World Wide Web Domain names. However, if it can be shown that Marketing cost centers are supportive of IP specific to a geographic market that does not benefit the cost sharing participant's territory, then such cost centers would be excluded. All other non-routine costs centers should be included in the cost sharing pools.

Marketing -
Marketing costs consist of primarily online advertising, including through the taxpayer's Associates and Syndicated Stores programs, sponsored search, portal advertising, e-mail campaigns, and other initiatives. Commissions paid to participants in the taxpayer's Associates program when their customer referrals result in product sales and classify such costs as "Marketing". The taxpayer also participates in cooperative advertising arrangements with certain of our vendors, and other third parties. Marketing expenses also consist of public relations expenditures; payroll and related expenses for personnel engaged in marketing, business development, and selling activities; and to a lesser extent, traditional advertising such as newspaper inserts.[7]

It is the Government's position that all Marketing cost centers that are supportive of IP that benefits Amazon's European business should be included in the Development Program. Since marketing activities that benefit Amazon's global business as a whole would benefit the European website business, such activities and their supportive cost centers would e included in the Development Program. All costs that are charged to cost centers that support the Marketing activities included in the Development Program should be included in the IDC cost pool, unless specifically excluded by regulation (depreciation, interest and income taxes). Marketing programs aimed directly at a specific geographic market (such as marketing projects directed solely at the U.S. market) would not benefit the European website business and therefore would not be included in the Development Program.

In addition, Marketing activities and the respective cost centers may support functions that are routine in nature (such as selling or distribution functions) and thus do not support the development of IP. If it can be shown that Marketing cost centers are geographically specific or support an activity that is routine and not supportive of IP, then it would be proper to exclude such cost centers form the IDC cost pools. However, the geographical market, as well as the routine function, must be identifiable.

[7] SEC Form 10-K For the Fiscal Year Ended December 31, 2005.

Marketing cost centers fall into 2 sub-categories: Business Development and Marketing (C160). The taxpayer included several cost centers from each sub-category in the cost sharing pool (IP) as supporting Marketing IP. However, most cost centers were excluded. The Government did not take exception to any excluded Marketing cost centers in tax years 2005 and 2006.

Technology & Content -
Technology and content expenses consist 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. Spending in technology and content includes computer scientists and software engineers employed to enhance the customer experience on the taxpayer's own websites and other websites powered by Amazon and to improve process efficiency. In addition, Tec & Content includes further development of technology, including seller platform technology, A9.com technology (search technology used on *www.A9.com*, *www.amazon.com*, and other Amazon sites), web services; and digital initiatives.[8]

It is the Government's position that the cost centers that support Technology and Content activity are generally similar to GAAP R&D expenses and generally do not benefit a specific geographically market only and are not supportive of a routine function. In addition, the taxpayer's own Agreement does not specifically exclude any Amazon activities from the Development Program. Since the Agreement is inclusive of all Amazon's IP development activities, then all Tech and Content cost centers should be related to the Development Program and thus included in the IDC cost pools. Therefore, it is the Government's position that there should be no Tech & Content costs excluded from the IDC cost pool.

Technology and Content cost centers fall into two sub-categories: Product Development (C210) and Technology (C250).

To determine whether a cost center is included in the IDC cost pool, the taxpayer reviews the cost center name. If the cost center name appears to capture the costs associated with the development activity it is designated as "included". Otherwise it is "excluded". The Government takes exception to the exclusion of costs from many Tech & Content cost centers as explained below.

[8] SEC Form 10-K For the Fiscal Year Ended December 31, 2005.

G&A -
The taxpayer also designates certain G&A cost centers as included or excluded. "Included" G&A cost centers are allocated to the IDC cost pool using a ratio of the total included Marketing and Tech & Content costs to the total (included and excluded) costs. The Government did not take exception to any excluded cost centers in tax years 2005 and 2006.

Excluded Costs
The taxpayer improperly excludes costs from the cost sharing pool by applying the following -

1. A reduction of certain included cost centers by applying a "Developer Ratio" percentage (applied to Tech & Content cost centers only).
2. A reduction of certain included cost centers by additionally applying a "QRE Ratio" percentage (applied to Tech & Content cost centers only).
3. A reduction of all included cost centers by excluding certain GL accounts charged to the included cost centers.

Based on the Government's position, that all costs are included, the following are descriptions of audit adjustments increasing the IDC cost pools and the Government's specific reason:

	2005	2006
1. Developer Ratio Percentage	52,438,339	194,711,285
2. QRE Ratio Percentage[9]	-0-	138,522,123
3. GL account No. A6100 Roll-up	8,841,293	4,099,017
4. Misc GL Accounts	-0-	3,195,514
5. GL Account 64327-Internal SW Deprec	10,920,895	-0-

2005 Original Return - As mentioned above, there are two sub-categories under Tech & Content: Product Development and Technology. For each included cost center under the Product Development sub-category, the taxpayer applied the developer percentage to reduce the included costs. The taxpayer did not apply the developer percentage to the Technology cost centers that were designated as "included". The taxpayer did not apply the developer percentage to any of the Marketing cost centers that were designated as "included". The taxpayer did not apply the QRE percentage to any Tech & Content or Marketing cost centers. The taxpayer also excluded certain general ledger accounts from the included cost centers.

[9] The taxpayer did not reduce the included cost centers by a QRE Ratio percentage on their tax year 2005 return. However the taxpayer has filed an informal claim requesting an adjustment to allow such reduction. The Government's position does not allow such informal claim adjustment.

2006 Original Return – The taxpayer applied both the developer percentage and the QRE percentage to all included Tech & Content cost centers and Marketing cost centers. So all included cost centers were reduced. The taxpayer also excluded certain general ledger accounts from the included cost centers.

2005 Informal Claim - On February 25, 2010, the taxpayer submitted an "Affirmative Claim" which was memorandum requesting an adjustment to reduce the 2005 cost sharing payment by $59,752,000. The taxpayer's claim methodology applied both the developer percentage and the QRE percentage to all included Tech & Content cost centers and Marketing cost centers. So all included cost centers were reduced. The taxpayer also excluded certain general ledger accounts from the included cost centers.

<u>1. Developer Percentage –</u>
The taxpayer reduced the total cost of cost centers that were determined to support the Development Program (IP) by applying a "developer percentage". For each included Tech & Content cost center, the taxpayer determines the total number employees charged to it. The taxpayer then determines the number of employees with an employee job codes beginning with the letter "T". The letter "T" is a designation that a particular employee is a "Developer". All other employees are considered "non-developers".[10] The Developer Percentage is computed for each cost center and is the ratio of developers to total number of employees. The taxpayer then applies the Developer Percentage to each cost center cost to determine the includable amount of each cost center. In many cases, the Tech & Content cost center costs were reduced to zero as there were no "developers" in the cost center.[11]

By applying a Developer Percentage to all included cost centers, the taxpayer removes costs from cost centers without showing that such eliminated costs support another activity or function. As stated above, all costs must be supportive of an activity undertaken by an enterprise. It is evident that since the taxpayer is unable to show what functions or activities the eliminated costs support, such eliminations are arbitrary and contrary to GAAP. It is the Government's position that the eliminated costs are

[10] An employee's job code is determined by Amazon's Human Resources Department. We asked for the criteria used for designating an employee's job code with a "T". We were provided with the job titles, including descriptions and responsibilities. These included data engineers, database administrators, Tech program managers, QA engineers, programmers, software development engineers, and system administrator engineers.

[11] Although most of the "Developers" were charged to included Marketing and Tech & Content cost centers, there were many "Developers" charged to excluded cost centers. This is an inconsistency in the taxpayer's theory that only costs related to "Developers" support Amazon's IP, as the taxpayer did not make any adjustment to include any of these costs.

supportive of the cost centers charged and should not be eliminated by a Developer percentage.

It is the Government's position that reducing included cost center's total cost by applying a Developer percentage improperly excludes costs from the IDC cost pools. This method does not reflect sound economic, financial or accounting principles for costing functions and activities undertaken by a for-profit organization. The criteria for determining whether an employee is classified as a "developer" by Amazon's Human Resources division no bearing or logic with respect determining which costs are applicable to an enterprises functions and activities. Therefore the Government proposes an adjustment to eliminate the application of the Developer percentage to all cost pools that support the Development Program. In addition, the Government denies the taxpayer's 2005 claim because it incorporates the Developer percentage in the method used to compute their claim.

2. QRE Percentage -
It is the Government's position that reducing included cost center's total cost by applying a QRE percentage improperly excludes costs from the IDC cost pools. Similar to the discussion above regarding the Developer Percentage, this method does not reflect sound economic, financial or accounting principles for costing functions and activities undertaken by a for-profit organization. Again, this method is contrary to GAAP. The taxpayer feels that the criteria for determining costs that qualify as expenditures for purposes of determining the R& D Credit under IRC section 41 is appropriate for determining costs that support the IDA. The Government contends that IRC section 41 has no authority and is not applicable for determining which costs are applicable to an enterprises functions and activities. Similarly to the Developer Percentage costs eliminations, the taxpayer is unable to show what functions or activities the eliminated costs support. This is because the eliminated costs are supportive of the cost centers charged and should not be eliminated by a QRE percentage. Therefore the Government proposes an adjustment to eliminate the application of the QRE percentage to all cost pools that support the Development Program. In addition, the Government denies the taxpayer's 2005 claim because it incorporates the QRE percentage in the method used to compute their claim.

3. GL account No. A6100 Roll-up and 4. Misc GL Accounts
The taxpayer's internal books of account include general ledger (GL) accounts that are charged to the respective cost center in which such GL account relates or supports. That is to say, all cost centers are made up of general ledger accounts that support that cost center, presumably, in accordance with U.S. GAAP. Such cost centers then roll up to the functions/activities for which they support. The cost centers ultimately roll up to

the summary functions reported on the GAAP financial statements (Consolidated Statement of Operations). Therefore, if a cost center supports the Development Program, then all underlying operating expense GL accounts must be included, except for those accounts which are specifically excluded by Treasury Regulation (i.e., depreciation, interest expense, and income taxes.)

The taxpayer reviews all GL accounts names. Any GL account name that appears to indicate it should be charged to an "Operations Activity" or a "Sales Activity" is excluded, even if it is charged to an included Marketing or Tech & Content cost center. The Government's position is that the taxpayer's own accounting should be relied upon as it is presumably in accordance with GAAP. Therefore any GL account charged to a Marketing or Tech & Content cost center that supports an IDA and is not depreciation[12], interest expense or income tax expense[13] should be included in the cost sharing pool. Excluding GL accounts from included cost centers results in a methodology that diverts form GAAP. The Agreement and the Treasury Regulations requires that included costs be determined in accordance with U.S GAAP. In addition, GL accounts names alone do not determine whether such costs support an IDA, an "Operations Activity" or a "Sales Activity". It is the Government's position that GL accounts that are charged to cost centers that support the IDA should not be excluded from the cost sharing pool. Therefore an adjustment is made to include the applicable GL accounts that were improperly excluded.

GL accounts that make up cost centers which support routine functions such as distribution or selling activities should be excluded from the IDC cost pools because such cost would not be supportive of the IDA. As such, the GL accounts charged to the excluded cost centers would be excluded accordingly. The only GL accounts that are properly excludable from included cost centers are depreciation, amortization, interest expense and income taxes[14]. (Note: the taxpayer includes certain Depreciation GL accounts in lieu of a rental charge. The Government does not take issue with this as it appears reasonable for tax years 2005 and 2006.)

5. GL Account 64327-Internal SW Deprec –
Although the Treasury Regulation excludes Depreciation expense from the cost sharing

[12] Treasury Regulation 1.482-7(d)(1) includes operating expenses as defined by Treas Reg. 1.482-5(d)(3), but excludes depreciation or amortization.
[13] Treasury Regulation 1.482-5(d)(3) excludes interest expense, foreign & domestic income taxes and any other expenses not related to the operations of the relevant business activity. It is the Government's position that all general ledger expenses charged to a cost center is relevant to that cost center and therefore relevant to the activity in which that cost center supports.
[14] Treasury Regulation 1.482-7(d)(1).

pools, the Regulation requires an arms-length charge for the use of assets that benefit the Development Program. The taxpayer includes depreciation in lieu of a rental charge for using an asset in the Development Program. The Government does not raise issue with the taxpayer's method of using depreciation to approximate an arms length charge for the use of assets used in the Development Program. However, the taxpayer inadvertently excluded account 64327- Internal SW Deprec from the cost sharing pools in tax year 2005.[15] Accordingly, an adjustment is made to properly include this account.

TAXPAYER'S POSITION:

Issue 1: The taxpayer has indicated agreement only with the adjustment to include of GL Account 64327-Internal SW Deprec of $10,920,895 in the cost sharing pool for 2005.[16] The taxpayer does not agree with the adjustments that propose to include the other additional costs in the cost sharing pools.

Issue 2: The taxpayer does not agree to the disallowance of their informal claim.

CONCLUSION:

It is the Government's position that the taxpayer improperly excluded costs from the cost sharing pools. Consequently, the cost sharing payments from AEHT recognized by Amazon US in tax years 2005 and 2006 were understated and therefore were not arms length. Therefore, an IRC section 482 adjustment is made to increase cost sharing payments received as shown in the Adjustment section above.

It is the Government's position that the taxpayer's method of reducing included cost centers amounts by applying a QRE percentage is not proper. Therefore the February 25, 2010, informal claim to reduce the cost sharing payments recognized in 2005 is not allowed. Consequently, no adjustment is made with respect to the taxpayer's claim, as shown in the Adjustment section above.

Accordingly, taxable income on the Amazon.com's consolidated income tax return will increase by $23,032,018 in FYE 2005 and $109,889,346 in FYE 2006.

[15] See Response to IDR I-36, item 2.
[16] Response to IDR I-36.