The Tax Court Decision in VERITAS: A Comment

Alice Lin and Deloris R. Wright[1]

Introduction

On 10 December 2009, the United States Tax Court released its opinion in the transfer pricing matter involving VERITAS Software Corporation.[2] VERITAS develops, manufactures, markets, and sells advanced storage management software products. Its software products protect against data loss and file corruption, and are designed to provide rapid recovery after disk or system failure, manage and back-up systems without user interruption, automate movement and retention of unstructured information to improve performance, scale, and manageability of applications.

On 3 November 1999, VERITAS's US company (VERITAS US) and its subsidiary, VERITAS Ireland, entered into a cost sharing arrangement (CSA) to develop and manufacture storage management products. Pursuant to the CSA, VERITAS US transferred preexisting intangible property to VERITAS Ireland, for which VERITAS Ireland made a $166 million buy-in payment to VERITAS US.

To compute the buy-in payment, VERITAS US employed the comparable uncontrolled transaction (CUT) method based on certain third party agreements between VERITAS US and its OEM (original equipment manufacturer) customers. During an audit of the 1999-2001 tax years, the IRS disagreed with VERITAS's computation of the buy-in payment and issued a notice of deficiency that was based on the analysis of an independent economist who used the income method to compute the buy-in. This expert concluded that the payment should have been $2.5 billion. Prior to trial, the IRS changed economic experts and reduced the buy-in payment to $1.675 billion.

The difference between the positions taken by VERITAS and the IRS is largely explained by the IRS's definition of intangible property for which the buy-in must compensate VERITAS US. Specifically, the IRS included access to VERITAS US's research and development team, marketing team, distribution channels, customer lists, trademarks, trade names, brand names, and sales agreements in the list of intangibles for which the payment was required. VERITAS, on the other hand, included only the "covered" intangibles that existed at the time the CSA was promulgated.[3] The IRS use of the income method also contributed to the difference in the size of the buy-in payment, as will be seen later in this article.

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[1] The authors are with Wright Economics Inc in Golden, Colorado.

[2] *Veritas Software Corporation & Subsidiaries, Symantec Corporation v. Commissioner of Internal Revenue,* 133 TC No. 14, (2009).

[3] Covered intangibles are defined as any and all inventions, patents, copyrights, computer programs, flow charts, formulae, enhancements, updates, translations, adaptations, information, specifications, designs, process technology,

The Tax Court was asked to decide whether the buy-in payment was properly computed by VERITAS. In a scathing decision, the Court rejected the IRS's position, and held that VERITAS's approach to the buy-in was arm's length.

Brief Summary of Facts

In 1999, VERITAS US sold its products directly to customers and through original equipment manufacturers (OEMs), distributors, and resellers. VERITAS US entered into agreements with a number of OEMs under which VERITAS US provided the OEMs with its product(s) and the OEMs sold the products either bundled with their operating systems or as unbundled, separate products. Royalty rates regarding VERITAS US's OEM licenses ranged from 10 percent to 40 percent for bundled products and 5 percent to 48 percent for unbundled products. VERITAS US generally received a one-time license fee upon entering into the agreement and additional license fees each time the OEM sold VERITAS US's products bundled with an operating system.

Prior to 2000, VERITAS US had limited presence in Europe, Middle East, and Africa (EMEA) and Asia-Pacific and Japan (APJ). Although VERITAS US had sales and services offices and resellers globally, it had not been particularly successful outside the United States. Therefore, in an effort to increase overall sales, VERITAS US decided to strengthen its presence in the EMEA and APJ territories through several acquisitions as well as by establishing headquarters for its EMEA and APJ operations in Ireland.

As part of that restructuring, VERITAS US entered into a CSA with VERITAS Ireland on 3 November 1999. Under the CSA, VERITAS US assigned all of its existing European sales agreements to VERITAS Ireland. Similarly, VERITAS Ireland was given the rights to use the covered intangibles and to use VERITAS US's trademarks, trade names, and service marks in EMEA and APJ. In return, VERITAS Ireland agreed to pay VERITAS US royalties in exchange for the rights granted. The royalty payment included a prepayment amount (i.e., lump-sum payment) along with running royalties that were subject to revision to maintain an arm's length rate.

Thereafter, VERITAS Ireland began co-developing, manufacturing, and selling VERITAS products in the EMEA and APJ markets. These improvements, along with the establishment of new management, allowed VERITAS Ireland's 2004 annual revenues to be five times higher than VERITAS US's 1999 EMEA and APJ revenues.

The Tax Court Decision

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manufacturing requirements, quality control standards, and other intangible property rights arising in existence as of the effective date of the CSA that relate to the design, development, manufacture, production, operation, maintenance and/or repair of any or all of the products covered by the agreement.

At trial, the IRS's economic expert employed the income method to calculate the buy-in payment (for preexisting intangibles that were to be used by the parties to develop future technology under the cost sharing arrangement). These calculations were based on the assumption that the transfer of preexisting intangibles by VERITAS US was "akin to a sale" and should be evaluated as such. To value the transfer, the IRS expert aggregated the intangibles so that, in effect, he treated the transfer as a sale of VERITAS US's business, rather than a sale of each separate intangible asset. The aggregation of the intangibles was necessary, in the view of the IRS expert, because the assets collectively (the package of intangibles), possessed synergies and, as a result, the package of intangibles were more valuable than each individual intangible asset standing alone.

The IRS expert's valuation approach was based on a three-step analysis. First, he estimated the arm's length royalty amounts that would be due in each calendar year. Second, he computed a discount rate to use in step 3. And, in the third step, he calculated the buy-in payment as equal to the present value of the estimated royalty payments, discounted at the previously determined discount rate. Therefore, using a discounted cashflow analysis, he concluded that the requisite lump-sum buy-in payment was $1.675 billion and calculated as an alternative, a 22.2 percent perpetual annual royalty.

The Court rejected this approach, and ruled in favor of VERITAS, stating that VERITAS US's CUT method, with appropriate adjustments, is the best method to determine the requisite buy-in payment. The result was essentially confirmation of the amount obtained by VERITAS in its computations of the buy-in payment.[4] The Court modified VERITAS's approach to include more types of OEM agreements than used by VERITAS, and added payments for use of VERITAS US's trademark intangibles.

In summary, the Court rejected the IRS's method on the following premises: (i) IRS did not differentiate between the value of subsequently developed intangibles and pre-existing intangibles, thus including intangibles beyond what is required for the buy-in payment, (ii) IRS included intangibles such as access to VERITAS US's marketing and R&D teams, which are not among the intangibles recognized by the US transfer pricing rules, and (iii) IRS incorrectly assigned a perpetual useful life for transferred intangibles that have a useful life of 4 years. Each of these points is described in more detail in the next section.

Comments

While it is always dangerous to use Tax Court decisions as precedent in computing buy-in payments (now called platform contributions), it is especially difficult here. This is because, as

[4] The amount of the buy-in must be calculated by the parties after trial, and may be different from the original VERITAS figure. The point, here, is that the buy-in payment is significantly closer to the amount VERITAS put on its tax return than to the amount the IRS assessed on audit.

is well known, the US cost sharing regulations have been changing, i.e., the rules that were in effect during 1999 have been modified. Having said that, the approach taken in 1999 is not substantially different from the current approach, even though the terminology is slightly different and the thought process underlying the current regulations is more fully developed than was the case under the regulations in effect in 1999. Indeed, the IRS states that the new regulations are not "new law" but are, rather, a clarification of existing law.

Having said this, we believe that the Court addressed a number of important issues that should be kept in mind as companies seek to establish or maintain R&D cost sharing arrangements with US affiliates. The remainder of this article discusses some of those issues.

The Income Approach

We begin our comments with a discussion of the IRS's litigating position, i.e., its use of the income approach. During the past 15 years or so, IRS has formulated, modified, and enhanced its approach to cost sharing, and has concluded, in essence, that a cost sharing arrangement is nothing more than the sale of a business, or sale of a business opportunity. As such, IRS takes the position that the "buy-in"[5] should compensate the US company for its foregone profits. In other words, the US company could have developed the business itself and, in doing so, would have reaped the rewards associated with the business. By transferring that business opportunity to a related foreign company, the US taxpayer has transferred an income stream in perpetuity, and should be reporting the foregone profits associated with the business on its US tax return. Stated another way, the cost sharing regulations in effect today simply do not allow a US company to transfer the income stream attributable to a business opportunity to a foreign related entity.

The IRS's logic leads the IRS to several conclusions:

- The intangibles covered by the buy-in payment include not only the preexisting intangibles but also any intangibles that are developed subsequent to the formation of the CSA. The logic for this is, in part, that the preexisting body of knowledge that is incorporated in the US company's R&D department is (extremely) valuable to the development of future intangible property, and the US company should be compensated for this body of knowledge. This compensation takes the form of a portion (or all, depending on how one interprets the new regulations) of the profit attributable to the business that is based on the intangibles developed under the cost sharing arrangement.

- The expected life of the preexisting intangibles is perpetual. This conclusion comes from the fact that the body of knowledge "owned" by the US R&D department is the basis for

[5] The buy-in is now called a platform contribution. In this article, we continue to use the term "buy-in" because it is more easily understood.

all future intangible development. A corollary to this conclusion is that the value of the body of knowledge does not degrade over time; hence, the value of the transferred "package of intangibles" does not degrade over time.

- The income approach, which is a form of discounted cash flow analysis typically used in business valuations or purchase price allocations, is one of the proper valuation approaches because it, effectively, values the buy-in as the present value of the future stream of income attributable to the cost shared intangibles.

As will be seen, the Court rejected all three of the points just presented. The following sections provide more detail on the Court's apparent thinking, and the application of the decision to the current cost sharing regulations.

The IRS's "Akin" to a Sale Theory

The IRS's sale theory (which the decision calls the "akin" to a sale theory) essentially treats a cost sharing arrangement as a sale of a business opportunity or a line of business. To value this approach, the IRS expert apparently included VERITAS Ireland's access to VERITAS US's marketing and R&D teams and VERITAS US's trademarks, trade names, customer base, customer lists, distribution channels, and sales agreement in the intangibles that he recognized in determining the requisite buy-in payment.

The Court objected to this approach on two grounds. First, the additional "intangibles" are not intangibles under the US transfer pricing rules. Intangibles are clearly defined by US transfer pricing law[6] and do not include such things as "access to an R&D or marketing team." Further, the US transfer pricing regulations are equally clear that to be an intangible, an asset must be separable from the services of an individual, and must be legally transferrable. Some of the intangibles included in the IRS approach fail both of these requirements, e.g., access to the R&D and marketing teams.

We note that the Obama administration has announced that it intends to modify the US rules to include such items as "workforce in place," "going concern value," and "goodwill" in the list of intangibles. This is clearly an attempt to allow IRS to treat many transfers as "sales" rather than as licenses, but as yet, this change has not been made.

Second, the Court concluded that the IRS approach includes intangibles developed after the onset of the CSA. Because the IRS believes that the pre-existing intangibles serve as the foundation for the development of future intangibles, the IRS's computation of the buy-in has to include the value of the future intangible property in order to properly compensate the contributor of the preexisting intangible. The Court rejected that analysis and asserted that the valuation of the

[6] See Section 936(h)(3)(B).

buy-in payment must be based solely on the preexisting intangibles. This is a very clear rebuke of the IRS's sale theory.

Expected Life of Preexisting Intangibles

The Court rejected the IRS assumption that the expected life of the pre-existing intangibles is perpetual. The IRS argues, implicitly, that the preexisting intangibles have an infinite life because they are the basis for all future intangible development. This point is elucidated in the current cost sharing regulations through the discussion of the rights that are transferred as part of the cost sharing arrangement. Specifically, the "make/sell" rights to an intangible give the licensee the right to use the licensed intangibles to make and sell a product. These rights clearly decline in value over time as competitors design and sell products that compete with the licensee's product. In addition, these rights have a finite life, as the intangibles will be replaced at some point by newer technology.

On the other hand, the intangibles made available under a CSA have a perpetual life (according to the IRS) because the knowledge that is developed by the firm's R&D department is used to develop all future intangibles, and the IRS argues that this value continues to exist in perpetuity and does not decline in value over time because it is, effectively, a body of know-how that will be used in all future R&D efforts.

The Court rejected this approach by valuing the buy-in using VERITAS's third-party OEM agreements, which presumably transferred "make/sell" rights to the OEMs. In addition, the Court assigned a finite life to the preexisting intangibles and concluded that the royalty should decline over time.

The IRS's Aggregation Analysis

One of the IRS's principal reasons for using the income method is that it values all the transferred rights in the aggregate, which the IRS believes will produce more reliable results because it takes into account the synergistic value of the transferred intangibles. Both the regulations in effect in 1999 and the current transfer pricing regulations state that the "combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most *reliable means* of determining the arm's length consideration for the controlled transactions."[7]

However, the Court concluded that aggregation does not increase reliability in this case, and rejected the IRS approach. The Court based its conclusion on the following:

[7] Section 1.482-1(f)(2)(i).

- In its aggregation approach, the IRS incorrectly included items that were not considered intangible property under the US transfer pricing rules, as discussed above.

  According to evidence presented at trial, VERITAS US's presence in EMEA and APJ was so minimal that its distribution channels, customer base, and customer lists had very little value. To a certain extent, VERITAS Ireland's access to VERITAS US's R&D team is already included in the Agreement for Sharing Research and Development Costs (RDA) as the signatories agreed to pool their respective resources and R&D efforts related to software products and software manufacturing processes. Moreover, the IRS economic expert admitted that it did not even consider the access to the marketing and R&D teams in its valuation.

- The IRS included the value of future intangibles that were co-developed pursuant to the cost sharing agreement in its determination of the requisite buy-in payment. This point has already been discussed and it not repeated here.

The Evaluation of Transactions as Originally Structured by Taxpayer

Both the transfer pricing regulations in effect in 1999 and the current regulations state that the results of a transaction should be evaluated as it was originally structured by the taxpayer unless that structure lacks economic substance. Specifically, Section 1.482-1(f)(2)(ii) states, "the district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance."[8]

VERITAS structured its buy-in transaction as a license of technology and not as a sale of a business. The Court held that VERITAS Ireland did not lack economic substance. In fact, the Court stated that its establishment was necessary and critical in expanding VERITAS US's presence in EMEA and APJ. As a result of the restructuring that included formation of the cost sharing agreement, VERITAS Ireland's 2004 annual revenues were five times higher than VERITAS US's 1999 EMEA and APJ revenues. Receiving minimal assistance from VERITAS US, VERITAS Ireland established strong and efficient supply chains and distribution channels to the EMEA and APJ territories. Therefore, the Court concluded that VERITAS Ireland did, in fact, have economic substance and satisfied legitimate business needs. Therefore, the Court concluded that the IRS should have valued the buy-in using the structure established by VERITAS, i.e., by determining an arm's length royalty rate.

This is an extremely important point. The Court is sending a strong message that IRS cannot simply restructure transactions because it does not like the results obtained by that structure. Of course, this is not new. The Lilly and Searle Tax Court cases[9] dealt with the same issue more

[8] Section 1.492-1(f)(2)(ii)
[9] Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1131 (1985) and G. D. Searle & Co. v. Commissioner, 88 t. C. 252, 359 (1987).

than 20 years ago. The issue in those cases was whether the IRS could ignore transfers of intangibles to Puerto Rican operations, and treat those manufacturing companies as contract manufacturers. In numerous other cases, IRS attempted to do the same thing, i.e., ignore transfers of intangibles to non-US jurisdictions, and treat the off-shore manufacturers as low-risk contract manufacturers. As a result of the losses in Tax Court, these efforts were ultimately abandoned by IRS. This led to the inclusion of the clause cited above, i.e., IRS will respect the taxpayer's form unless it lacks economic substance. The VERITAS decision is yet another example of IRS over-reaching in its attempt to restructure a company's intercompany transactions to maximize the US tax base.

The Court's Computation of the Buy-In Payment

The CUT method produces the most reliable arm's length consideration for the transfer of intangibles when it can be applied. However, it is not commonly utilized because economists have been concerned about its stringent comparability requirements. Specifically, it has been commonly believed that application of the CUT method requires that the uncontrolled and controlled transactions involve very similar intangible property, and it is difficult to identify publicly available contracts between unrelated third parties that achieve the required degree of comparability.

The Court's approach seems to have weakened the comparability requirements to apply a CUT method. In the ruling of this case, the Court chose to exercise looser standards of comparability than has been previously applied. The Court deemed VERITAS's unbundled license agreements with OEMs as comparable to the controlled transfers, apparently because it believed that these agreements transferred essentially the same intangibles. The IRS argued that the uncontrolled transfers included the license agreements of select products whereas the controlled transfer included the licensing of the full range of VERITAS US's products.

Ultimately, the Court accepted VERITAS's CUT method, with adjustments, as the most reliable method for determining arm's length consideration of the transferred preexisting intangibles. Upon reviewing the comparability requirements detailed in Section 1.482-1(d), the Court concluded that the bundled license agreements were not comparable because there was value associated with the OEMs credibility and brand name. Therefore, the Court concluded that the unbundled products were sufficiently comparable to the controlled transactions at issue.

It is tempting to conclude that the Court is signaling a willingness to apply much weaker comparability standards than are typically used in applying the CUT method. This point must be interpreted in connection with the IRS intent to tighten the comparability requirements to prohibit use of the CUT method, except in cases were exact comparables are available.

Use of Mean Rather than Median

The Court used the mean (or average) royalty rate from the unbundled products' license agreements, rather than the median (the middle observation) in its application of the CUT method. The implications of this are obvious.

The mean is computed using all the observations obtained from the comparable transactions, while the median is simply the middle observation, without regard to the variability inherent in the data. IRS has argued that the median should be used so that "outliers" are not allowed to influence the best point within the arm's length range (which eliminates outliers when it computes the interquartile range). It is tempting to interpret this as a rejection by the Court of the IRS's conclusion that outliers should be disregarded; however, the Court does not mention this decision, and care should be taken not to read too much into this point.

Implications for the 2009 Temporary Cost Sharing Regulations

The Court was clear in its ruling that it was using the cost sharing regulations in effect during 1999. It is interesting, however, to wonder about the implications of this decision for the current regulations. How will the Court react to the new regulations when/if a similar case is presented to it under the current regulations?

The IRS and the Treasury Department issued the temporary cost sharing regulations on January 5, 2009 in an effort to tighten regulations surrounding the transfer of intangibles. The Treasury states that these regulations are a "clarification" of existing law, rather than new law. Although the Court's decision has no direct influence on the temporary cost sharing regulations, some of the Court's determinations could have an impact on the interpretation of the temporary cost sharing regulations in future buy-in valuations. The Court's preference of the mean over median, looser standards of comparability, rejection of the IRS's aggregation analysis, and rejection of the concept that today's intangible property has infinite life because it is the foundation for tomorrow's intangible property, are expected to shed some light on the Court's approach to buy-in valuations under the temporary regulations.

The 2009 temporary cost sharing regulations, which are essentially an expansion of the 2005 proposed cost sharing regulations, still accept the use of the CUT method in the valuation of buy-in payments. However, the language from the temporary cost sharing regulations suggests that the comparability requirements under the CUT analysis will be considerably more stringent than previously was the case. In fact, as stated above, various IRS and Treasury spokespeople have publicly stated their desire to rewrite the CUT regulations to limit their applicability to situations where exactly comparable CUT transactions exist.

It is important to acknowledge that the IRS's economic expert did not provide very compelling arguments for his position, which must be taken into account in evaluating the implications of this decision. Without having been in the courtroom or having seen the expert reports that IRS used in its initial assessment (which expert did not testify at trial) or the testifying expert, it is

dangerous to reach conclusions about the quality of their analyses. Suffice it to say, the Court was not impressed with either of these witnesses, and was, in fact, scathing in its description of their analyses and testimony.

Conclusion

The VERITAS decision was a clear, convincing (and often-times hostile) repudiation of the IRS's approach to valuation of buy-in payments. IRS has invested considerable time and resources to developing its litigating position, and the Court rejected virtually 100 percent of that approach. Specifically, the Court explicitly or implicitly rejected

- The IRS's sale theory, i.e., that a cost sharing agreement is the sale of a business or a business opportunity,
- The IRS's view that the body of intangibles transferred to the cost sharing arrangement should include access to the US company's R&D and marketing teams, and
- The IRS's view that the intangibles transferred have more value in the aggregate than the separately valued sum for each intangible, i.e., that the aggregation rules should be used to include the "synergetic value" of the basket of transferred intangibles.

In addition, the significant conclusions reached from evaluation of the Court's determination of the buy-in payment suggest that

(1) The standards of comparability for application of the CUT method are more relaxed than previously thought,

(2) The mean, rather than the median, should be used to determine the starting point in applying the CUT analysis,

(3) The buy-in should value the "make/sell" rights rather than the rights to use the intangibles to develop future technology,

(4) The expected life of the transferred intangibles is limited (not perpetual), and

(5) The arm's length royalty for the transferred intangibles should decline over time.

In short, this decision seems to be consistent with buy-in analyses that were employed some 25 years ago, before cost sharing agreements became the subject of highly focused and debated analyses. If one accepts the IRS's statement that its current temporary cost sharing regulations are merely a clarification of existing law, then the Court seems to be sending a strong message that it does not agree with those regulations.

As stated earlier, it is dangerous to read too much into this decision as it is based on the specific facts evident in the VERITAS situation; however, it is clear that the future of the IRS's position on buy-in payments has suffered a severe blow. The question will be whether the IRS appeals the decision, and if it does, how the Ninth Circuit decides that appeal. As with the Xilinx case (which is subject of a previous article in this journal), the story does not end here, and there are more Court battles and decisions to come.