DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

IRB No. 2010-49
December 6, 2010

ACTION ON DECISION

Subject: VERITAS Software Corp. v. Commissioner,
133 T.C. No. 14

Issue:

Whether the United States Tax Court erred in concluding that the comparable uncontrolled transaction (CUT) method, with adjustments, was the best method to determine an arm's length result.

Summary:

The Internal Revenue Service (Service) believes the Court's factual findings and legal assertions are erroneous. Therefore, it does not acquiesce in the result or the reasoning of the decision.

Facts and Background:

On November 3, 1999, VERITAS US (VUS), a domestic corporation, and its wholly owned foreign subsidiary, VERITAS Ireland (VI), entered into a cost sharing agreement (CSA) that provided that they share the costs of developing intangibles for exploitation in their respective territories (as outlined in the CSA), and provided for payments by VI for the availability of VUS's pre-existing intangibles for purposes of research in the intangible development area (R&D rights). Each party was to pay a percentage of the total research and development (R&D) costs in proportion to its reasonably anticipated benefits from the technology to be developed pursuant to the CSA.[1] VUS and VI (collectively "Taxpayer") simultaneously entered into a number of related transactions, evidenced either by written contracts or the parties' conduct, whereby VUS made available to VI (1) the right to manufacture and sell existing software products (make-sell rights); (2) the services of VUS's R&D and marketing teams; (3) the distribution relationships and channels involving both related and unrelated parties; and (4) the rights in VUS's trademarks and trade names for use in conjunction with VI's exploitation

[1] These are referred to as "covered intangibles" in Treas. Reg. § 1.482-7(b)(4)(iv).

of its territories (Europe, the Middle East, Africa, Asia, and the Asia Pacific) (collectively, along with the R&D rights, the “intangibles and services package”).

After an audit, the Service issued VUS a notice of deficiency for taxable years 2000 and 2001, proposing adjustments to the payments required under section 482 from VI to VUS with respect to the interrelated transactions. VUS filed a petition in the Tax Court. After a trial and post-trial briefing, the Court held that the Service’s adjustments based on an income method were arbitrary and capricious and also held that Taxpayer’s CUT method, with minor adjustments by the Court, was the best method.

Discussion:

An arm’s length result is determined under the method, or application of a method, that provides the most reliable measure under all the facts and circumstances.[2]

In developing the case, the Service made factual determinations on which its transfer pricing analysis was based. In particular, the Service determined that the software and related technology that VUS brought to the table when it entered into the CSA with VI was expected to serve as the foundation for future development of valuable intangible property and products. That is, the Service determined the VUS intangibles were expected to contribute not only to income anticipated from sales of existing products (i.e., the make-sell rights) but also to income anticipated from sales of future products that would incorporate the new intangibles resulting from the R&D pursuant to the CSA (i.e., the R&D rights). Importantly, the Service also determined that VI expected to significantly benefit from all the elements of the intangibles and services package. The Service determined that the combined effect of these interrelated transactions could be most reliably valued in the aggregate, rather than separately.

The facts found by the Court materially differed from the determinations made by the Service. In light of advances in the rapidly changing and highly competitive market as found by the Court, the Court found, in effect, that the technology that VUS transferred to VI had little or no value beyond the value of the current generation product line and, therefore, the make-sell rights in that current generation. See VERITAS Software Corp. v. Commissioner, 133 T.C. No. 14, slip op. at 7-16 (December 10, 2009).[3] The Court found that VUS’s existing products were continually made obsolete by technological

[2] Treas. Reg. § 1.482-1(c)(1). In pertinent part, this provides:

> The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. … [I]f two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

[3] Accordingly, the Court found the useful life of the technology was limited to the life of the make-sell rights. Id. at 45-46. To the extent the Court may be understood as implying that technology never has value in excess of the current generation product line that incorporates such technology, the Court’s implication is erroneous and fails to recognize that, in circumstances where R&D rights in technology do have value, the economic life of that technology necessarily exceeds the useful life of the current generation product line or the make-sell rights.

advances in computer storage software and hardware. Id. Thus, the Court found that the pre-existing technology had no ongoing R&D value[4] and that the value of the technology developed under the CSA was not attributable to such pre-existing technology. Similarly, the Court found that the marketing contributions that VUS made to VI did not contribute value, but that VI's marketing success was attributable to its newly-hired sales manager, aggressive salesmanship, and savvy marketing. Id. at 22, 41-43, and 50. The facts as found by the Court would remove the underpinnings of the Service's valuation.[5] The Court factually excluded the possibility of any value attributable to the R&D rights and other elements of the intangibles and services package which the Service's income method was intended to measure. The only matter left to value, under the Court's fact findings, was the make-sell rights for whose valuation the adjusted CUT was suited. The Service believes these findings of fact were erroneous.

Because the Court's factual findings eliminated the basis for the Service's valuation, and correspondingly supported the Court's valuation, it was unnecessary for the Court to make the broad assertions it made about the governing law. As those assertions are erroneous and could be inappropriately relied on by taxpayers in planning future transactions, they are discussed below.

Treas. Reg. § 1.482-7(g)(2) provides in pertinent part "[i]f a controlled participant [in a CSA] makes pre-existing intangible property … available to other controlled participants for purposes of research in the intangible development area … then each such other controlled participant must make a buy-in payment to the owner." The court construes the buy-in to exclude any consideration of the future income or value attributable to intangibles to be developed under a CSA, apparently on the theory that such future income stream is already paid for through the participants' cost shares of ongoing R&D. Id. at 30-31, 44-45, 59. However, the expected ongoing R&D cost only partially accounts for the expected value of subsequently developed intangibles. Pre-existing intangibles may be expected to afford a headstart to intangible development that the ongoing R&D may exploit to advantage. The value of that headstart in contributing, along with the ongoing R&D, to the possibility of income from intangibles developed under the CSA, is in addition to the value of exploiting the pre-existing intangibles in their present applications, i.e., the R&D rights are in addition to the make-sell rights

[4] The Court mischaracterizes the Service as contending that the pre-existing intangibles had a "perpetual" useful life. Id. at 28, 30, and 45. The Service's income method effectively valued in the aggregate the lift in business results projected from operating with, as compared to operating without, the benefit of the intangibles and services package. This lift can be represented as the area between two curves mapping such results over time, i.e., with and without the benefit of such package. Because businesses do not tend to project a termination of operations, both curves individually may possibly have infinite tails. Typically, however, there is a time period beyond which the two curves intersect, or after which the remaining area in the tail between the curves is negligible. The time period until the two curves intersect is the useful life of the pre-existing intangibles.

[5] Certain factual findings made by the Court related to the income method, such as the appropriate rate for discounting to present value financial projections, see id. at 46-49, and the growth rate for the profits attributable to the intangibles transferred, see id. at 49-50, were unnecessary because, for the reasons discussed in the text, the basis for the income method had already been removed.

associated with the pre-existing intangibles. The regulations clearly prescribe the buy-in to compensate these additional R&D rights, "pre-existing intangible property … for purposes of research in the intangible development area …." Thus, if a cost sharing participant makes pre-existing intangible property available for purposes of research under a CSA, under the regulations that participant's additional contribution to the R&D project must be compensated over and above the proportionate sharing of future R&D costs and over and above the compensation required for any rights to make and sell existing products. From the quoted sentence of the regulation, the Court focuses on the words "pre-existing intangible property" and then incorrectly deduces that such language excludes consideration of subsequently developed intangibles. The Court reads out of the regulation the critical phrase "for purposes of research in the intangible development area." Read together, as the context requires, the buy-in payment relates to making available "pre-existing intangible property … for purposes of research in the intangible development area." The Court's interpretation that the relevant value is only for the make-sell rights, and does not include the value attributable to the R&D rights, is erroneous. The plain meaning requires that the buy-in payment compensate for the value of making available the "pre-existing intangible property ... for purposes of research in the intangible development area."[6] Therefore, under the regulations, a valuation method must take into account the income from intangibles resulting from the pre-existing intangibles made available for R&D purposes.

Regarding the R&D and marketing team elements of the intangibles and services package, the Court in a footnote states the view that they do not have substantial value independent of the services of any individual and thus do not come within the intangible definitions of section 936(h)(3)(B) or Treas. Reg. § 1.482-4(b). Id. at 43, n.31.[7] The Court ignores that, depending on the facts and circumstances, an experienced and successful team's contribution to value may substantially exceed the total compensation expense to employ the individual team members, and similarly may be independent of the services of any individual team member who may be replaced without materially affecting the team as a whole. This is especially true where the relevant value stems not merely from the R&D and marketing teams in isolation, but from their interrelationship in combination with other important elements in an intangibles and services package such as in this case.[8]

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[6] Thus, the Service's position is anchored squarely in the regulations applicable to the years in question. The Court's suggestion that such position reflects subsequent temporary regulations is mistaken.

[7] The Service sees no legal basis for the Court's inference that a "change in law" is signified by the revenue estimate associated with the FY 2010 budget proposal regarding the intangible status of workforce in place, goodwill, and going concern value. See id. at nn. 25, 31, and accompanying text. That proposal by its terms is expressly a clarification and not a change.

[8] In determining the arm's length compensation owing between related parties for furnishing the benefit of the services of a team, the existence or transfer of intangible property as defined in Treas. Reg. § 1.482-4(b) is irrelevant to valuing the team's services (either separately, or as part of a package in the aggregate along with furnishing the benefit of embedded pre-existing intangibles, as appropriate under the facts and circumstances). See Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983)(no transfer of intangibles, but compensable services).

The Court also criticized the Service's application of an aggregate valuation of the interrelated intangibles and services transactions, what the Court referred to as the "akin to a sale" theory. See id. at 39-41. Again, the opinion suggests the Court believed there was an absence in the factual record of a basis for an aggregate valuation under Treas. Reg. § 1.482-1(f)(2)(i).[9] The Service, however, will continue to apply an aggregate valuation to interrelated transactions related to a CSA where, under the facts and circumstances, such valuation provides the most reliable measure of an arm's length result.[10]

[9] The first sentence of Treas. Reg. § 1.482-1(f)(2)(i)(A) provides:

> 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.

[10] Contrary to footnote 29 of the opinion, the characterization of one or more component transactions in a package as a sale, license, or services is irrelevant to its aggregate valuation. Related parties enjoy great flexibility in determining the legal form of controlled transactions. Nevertheless, where transactions of different legal form produce economically equivalent results, the transactions may most reliably be measured under similar methods.

Recommendation: The Service believes the Court's factual findings and legal assertions are erroneous. Therefore, it does not acquiesce in the result or the reasoning of the decision.

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