Veritas Software Corp. & Subsidiaries, Symantec Corp. (Successor in Interest to Veritas Software Corp. & Subsidiaries) v. Commissioner of Internal Revenue, 133 T. C. 297 (2009)

In Veritas Software Corp. v. Commissioner, the U. S. Tax Court ruled that the IRS's method for calculating a buy-in payment for the transfer of preexisting intangibles in a cost-sharing arrangement was arbitrary and unreasonable. The court favored the taxpayer's use of the Comparable Uncontrolled Transaction (CUT) method, adjusted for specific factors, to determine the arm's-length payment. This decision underscores the importance of selecting appropriate valuation methods and the limitations on IRS adjustments in transfer pricing disputes.

Parties

Veritas Software Corporation & Subsidiaries (Petitioner) and Symantec Corporation (Successor in Interest to Veritas Software Corporation & Subsidiaries) were the petitioners. The Commissioner of Internal Revenue (Respondent) was the respondent in the case. The case was initially brought before the United States Tax Court as Veritas Software Corp. & Subsidiaries v. Commissioner of Internal Revenue, and Symantec Corporation became the successor in interest after acquiring Veritas.

Facts

On November 3, 1999, Veritas Software Corporation (Veritas US) entered into a cost-sharing arrangement (CSA) with its foreign subsidiary Veritas Ireland. The CSA consisted of a research and development agreement (RDA) and a technology license agreement (TLA). Pursuant to the TLA, Veritas Ireland was granted the right to use Veritas US's preexisting intangible property in Europe, the Middle East, Africa, and Asia. Veritas Ireland made a $166 million buy-in payment to Veritas US as consideration for the transfer of these preexisting intangibles. Veritas US calculated this payment using the Comparable Uncontrolled Transaction (CUT) method. The IRS, in a notice of deficiency, determined that the appropriate buy-in payment should be $2. 5 billion, based on an income method. This amount was later adjusted to $1. 675 billion in an amendment to the answer. The IRS's calculation took into account not only the preexisting intangibles but also access to Veritas US's research and development team, marketing team, distribution channels, customer lists, trademarks, trade names, brand names, and sales agreements.

Procedural History

Veritas US timely filed its Federal income tax returns for the years 2000 and 2001, reporting a $166 million lump-sum buy-in payment from Veritas Ireland. After an audit, the IRS issued a notice of deficiency on March 29, 2006, asserting that the cost-sharing allocations did not clearly reflect Veritas US's income. The IRS determined a $2. 5 billion allocation based on a report prepared by Brian Becker. On

June 26, 2006, Veritas US filed a petition with the United States Tax Court seeking a redetermination of the deficiencies and penalties set forth in the notice. On August 25, 2006, the Tax Court filed the Commissioner's answer, and on August 31, 2006, the Commissioner's amended answer. The IRS later reduced the allocation to $1. 675 billion based on a report by John Hatch, employing a discounted cash flow analysis. The Tax Court, after a trial commencing on July 1, 2008, issued its opinion on December 10, 2009, ruling that the IRS's allocation was arbitrary, capricious, and unreasonable.

Issue(s)

Whether the IRS's allocation of income under section 482 for the buy-in payment related to the transfer of preexisting intangibles was arbitrary, capricious, and unreasonable?

Whether Veritas US's use of the Comparable Uncontrolled Transaction (CUT) method, with appropriate adjustments, was the best method to determine the requisite buy-in payment?

Rule(s) of Law

Section 482 of the Internal Revenue Code authorizes the IRS to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among controlled entities if necessary to prevent tax evasion or clearly reflect income. The arm's-length standard must be applied in every case as per section 1. 482-1(b)(1) of the Income Tax Regulations. For cost-sharing arrangements, section 1. 482-7(g)(2) of the Income Tax Regulations requires a buy-in payment for the transfer of preexisting intangible property, which must be determined using the methods outlined in sections 1. 482-1 and 1. 482-4 through 1. 482-6 of the Income Tax Regulations. The Comparable Uncontrolled Transaction (CUT) method, described in section 1. 482-4(c), is one of the specified methods for determining the arm's-length amount charged in a controlled transfer of intangible property.

Holding

The Tax Court held that the IRS's allocation of income for the buy-in payment was arbitrary, capricious, and unreasonable. The court further held that Veritas US's use of the Comparable Uncontrolled Transaction (CUT) method, with appropriate adjustments, was the best method to determine the requisite buy-in payment.

Reasoning

The Tax Court found the IRS's allocation to be unreasonable because it was not based on reliable data or methods. The IRS's expert, John Hatch, employed an income method that included an incorrect beta, discount rate, and growth rate, and took into account items not transferred or of insignificant value. The court rejected the IRS's "akin" to a sale theory and its aggregation of transactions as not producing the most reliable result. The court also noted that the IRS's valuation included subsequently developed intangibles, which violated section 1. 482-7(g)(2) of the Income Tax Regulations.

The court favored Veritas US's CUT method, finding it to be the best method for determining the buy-in payment. The court made adjustments to the CUT analysis to enhance its reliability, including using a starting royalty rate of 32 percent of list price, a useful life of 4 years for the preexisting product intangibles, and a ramp-down of the royalty rate to account for obsolescence. The court also adjusted for the value of trademark intangibles and the need to account for transferred sales agreements. The court concluded that the appropriate discount rate was 20. 47 percent, based on reliable data used by Veritas US's financial markets expert.

Disposition

The Tax Court determined that the IRS's allocation was arbitrary, capricious, and unreasonable and that the CUT method, with specified adjustments, was the best method for determining the requisite buy-in payment. The court instructed that a decision would be entered under Rule 155, requiring the parties to compute the adjusted buy-in payment based on the court's findings.

Significance/Impact

This case is significant in the field of transfer pricing and cost-sharing arrangements, as it reinforces the importance of using the most reliable method to determine arm's-length payments for the transfer of intangibles. The court's rejection of the IRS's income method and "akin" to a sale theory highlights the limitations on the IRS's ability to make arbitrary adjustments. The case also underscores the need for taxpayers to provide robust and reliable data to support their transfer pricing methods. Subsequent courts and practitioners have referred to this case when addressing similar issues in cost-sharing arrangements and the application of section 482. The decision has practical implications for multinational corporations engaging in cost-sharing arrangements, emphasizing the need for careful analysis and documentation of the transfer pricing methodology used.

