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Articles

IN THIS ISSUE

Equity Swap Transactions with Foreign Entities Come Under Examination
The IRS issued a directive in mid January that will assist IRS agents in uncovering equity swaps that are used to avoid dividend withholding tax. The guidelines provide fact patterns for agents to probe for possible "dividend tax abuse." Financial institutions that come under review can expect significant compliance burdens. Page 2

Congress and Obama Administration Target Tax Havens
One bill recently introduced in the House and Senate would require foreign banks to disclose account information on U.S. individuals. Among the several penalties in the bill, understatement of income from an undisclosed foreign financial asset would subject the taxpayer to a 40 percent penalty. Page 3

Case Study for Companies Defending Transfer Pricing Methodology under Section 482
A recent decision by the U.S. Tax Court provides a case study for companies that value intangibles transferred under a cost sharing agreement. The decision could have a significant impact on current audits, the new temporary cost sharing regulations, and on transfers of intangibles. Page 5

Withholding Tax on Royalties, Dividends, Eliminated in New France-U.S. Tax Treaty
The zero rate of withholding on dividends and royalties applies to payments paid by a subsidiary to a parent that owns and controls the subsidiary. Page 10

Advisory Board page 6

Tax Court Upends IRS's Billion Dollar Buy-in Valuation Adjustment in *Veritas*

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In a closely watched case concerning the valuation of preexisting intangibles in cost-sharing arrangements (CSAs), the United States Tax Court handed the taxpayer a victory in *Veritas, Inc. v. Commissioner*, 133 T.C. No. 14 (2009), released December 10, 2009. At issue was the IRS's claim that preexisting intangibles contributed by Veritas Inc., a U.S. corporation (Veritas US), to a CSA with its Irish subsidiary (Veritas Ireland) had a value of more than $1.5 billion, nearly 10 times the value determined by the taxpayer. In a lengthy and sometimes strongly worded opinion, the court held that the IRS's valuation of these preexisting intangibles was "arbitrary, capricious, and unreasonable." The potential impact the decision will have on current audits, on the new temporary cost-sharing regulations, and, more generally, on purported transfers of intangibles, is significant.

Technology License Agreement

The basic facts of the case are similar to those in many CSAs. Through a technology license agreement (TLA), Veritas US granted rights to Veritas Ireland to conduct research and development under their CSA on various "covered intangibles" relating to data storage software and related devices. According to the TLA, such preexisting intangibles included various technology intangibles, such as computer programs, designs, and manufacturing process technologies.

Under the cost-sharing regulations in effect during 1999 through 2001, the years at issue in the case, Veritas Ireland was required to make a "buy-in payment" to Veritas US for this grant of rights. The taxpayer calculated the required buy-in payment to be approximately $160 million, which Veritas Ireland paid as a lump sum in 2000. This valuation was based upon royalty rates that Veritas US had received from seven original equipment manufacturers (OEMs) for rights to incorporate Veritas US's software and technologies into an operating system, adjusted along several dimensions. Veritas US contended that its application of the comparable uncontrolled transaction (CUT) method was the "best method" within the meaning of the Section 482[1] regulations for valuing the buy-in payment.

The court found that access to the marketing and R&D teams was transferred to Veritas Ireland or that such items had value.

$160 Million Adjusted to $2.5 Billion

In its notice of deficiency, the IRS adjusted the buy-in payment due from Veritas Ireland by magnitudes, up to $2.5 billion. At trial, however, the IRS abandoned the method upon which this adjustment was based and the independent economic consultant who had pursued it. Instead, the IRS adopted a report using a different methodology, authored by a different consultant who then testified on behalf of the IRS.

"Akin to a Sale"

This consultant characterized the agreements that comprised the taxpayer's CSA and the conduct of the parties as being "akin to a sale" of Veritas US's business (Opinion 39). On this view, the rights Veritas US granted

Transfer Pricing, continued on page 6

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Transfer Pricing *(from page 5)*

Veritas Ireland to its preexisting intangibles should be aggregated and treated as a sale of Veritas US's business rather than a sale of its discrete assets because the "assets collectively possess[ed] synergies that imbue[d] the whole with greater value than each asset standing alone" (Opinion 39). Using a discounted cash flow analysis, the consultant arrived at a lump-sum buy-in payment of $1.675 billion.

In addition, the IRS later amended its position to allege that Veritas US had granted rights not just to its technology intangibles, but also rights of access to Veritas US's marketing and R&D teams and rights to its trademarks, trade names, customer base, customer lists, distribution channels, and sales agreements.

The court was critical of the substance of the IRS's position and of the weaknesses of its presentation at trial. The court found the IRS's testifying expert witness's testimony to be "unsupported, unreliable, and thoroughly unconvincing" (Opinion 38). The court also faulted the IRS for using terms and concepts, such as "platform contribution," that appear only in the new temporary regulations released in January 2009, years after the audit period (Opinion 32).

The IRS's substantive position came under attack from the court on two important fronts: the valuation method it used and the scope of intangibles that were required to be valued. First, on the valuation method, the court determined that the IRS failed to support key elements of its "akin to a sale" theory. When asked whether he believed his valuation methodology accurately captured synergistic value, for example, the IRS expert testified that he "really [did not] have an opinion" (Opinion 39-40). The court also found that the IRS's valuation did not discriminate between the value of subsequently developed intangibles and the value of preexisting intangibles, thus going beyond what was required to be included in the buy-in payment (Opinion

Transfer Pricing, continued on page 7

Transfer Pricing *(from page 6)*

44-45). The theory also assumed that the preexisting intangibles had a perpetual useful life, despite evidence offered by the taxpayer (and even acceded to by the IRS expert) that preexisting intangibles in the relevant industry would "wither on the vine" within only four years (Opinion 45). Moreover, the court took issue with the discount and growth rates used in the IRS expert's analysis, highlighting the expert's own concession at trial that the discount rate he used was unreasonable (Opinion 38, 46-49).

Marketing Information is Not Compensable Intangible Property

Second, the court criticized the IRS's view on what intangibles were required to be valued. As indicated above, the IRS alleged during the trial proceedings that Veritas US granted rights to intangibles beyond those relating specifically to the development of technology, notably rights of access to Veritas US's marketing and R&D teams. Citing the ambivalent testimony offered by the IRS's expert, the court found that there was insufficient evidence to conclude that access to the marketing and R&D teams was either transferred to Veritas Ireland or that such items had value. In a lengthy footnote, the court added that even if such evidence *had* existed, these rights of access are not compensable "intangible property" within the meaning of the controlling statutory and regulatory framework of Section 936(h)(3)(B) and Treas. Reg. § 1.482-4(b) (Opinion 43-44, Footnote 31). The court observed that access to marketing and R&D teams is not among the specific intangibles recognized for purposes of Section 482. In addition, neither item is "similar to" any of the listed intangibles and neither has "substantial value independent of the services of any individual," because any value inherent in these teams is based upon the work, knowledge, and skills of individual team members (*Id.*). In this regard, the court rejected the IRS's arguments that existing case law, including the U.S. Supreme Court's decision in *Newark Morning Ledger v. United States* and the U.S. Fourth Circuit Court of Appeals' opinion in *Ithaca Industries v. United States*, supports the proposition that access to a R&D or marketing team qualifies under the criteria set forth above for recognition as an intangible under Section 482.

Access to marketing and R&D teams is not among the specific intangibles recognized for purposes of Section 482.

Clarifying or Materially Expanding Existing Law?

Further, in the same footnote, the court referred to the current initiatives on the part of the IRS and U.S. Treasury Department and the Obama Administration regarding the definition of intangibles. Although it did not opine on how these efforts bore on the present case or on their broader significance, one may infer from the court's discussion that it views the Treasury Department's effort to list workforce in place, goodwill, and going-concern value among the intangibles subject to Section 482 as no mere "clarification" of existing law, but rather as a material expansion of it.

It is natural to read the court's rejection of the IRS's position against the backdrop of the temporary cost sharing regulations, effective January 5, 2009, and the IRS's and Treasury Department's stepped-up efforts to curb what they consider abusive transfers of intangibles. From this perspective, the taxpayer's victory in this case is undoubtedly significant. The IRS stumbled in this case in its analysis of key facts and in its presentation of the underlying rationale for the income method, which is most extensively discussed in the Coordinated Issue Paper (LMSB-04-0907-62, Sep. 27, 2007) (CIP). The question remains, though, whether the *Veritas* court did not so much invalidate the IRS's income method—as that method is discussed in the CIP and incorporated into the temporary cost sharing regulations—as it did chastise the IRS for the predicates of its adjustment: questionable views on the scope of rights made available under the CSA; an unjustified presumption of perpetual life in an industry characterized by rapid obsolescence; and unsubstantiated assumptions about discount rates, growth rates, and other factors critical to the calculation.

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[1]Unless otherwise noted, all "Section" references are to the Internal Revenue Code of 1986, as amended.

Submission of Articles

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