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## **Veritas v. Comr.: Tax Court Finds IRS's §482 Allocations To Be "Arbitrary, Capricious, and Unreasonable"**

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### **INTRODUCTION**

A §482<sup>1</sup> allocation made by the Internal Revenue Service (IRS) must be sustained absent a showing of abuse of discretion and, in order to overturn a §482 allocation made by the IRS, the taxpayer must prove that the IRS's §482 allocation is "arbitrary, capricious, or unreasonable." On December 10, 2009, in *Veritas Software Corporation et al. ("Veritas") v. Comr.*,<sup>2</sup> the Tax Court found that the §482 allocations made by the IRS with respect to a buy-in payment by the taxpayer's Irish subsidiary under Regs. §1.482-7(g)(2) were "arbitrary, capricious, and unreasonable." Having so found, the court then went on to determine the appropriate buy-in payment.

This article reviews the *Veritas* decision with a view to understanding under what circumstances a

court will find a §482 determination by the IRS to be "arbitrary, capricious, or unreasonable." The article concludes with some thoughts as to whether *Veritas* might have been decided differently under the 2009 temporary cost-sharing regulations.<sup>3</sup>

### **COMPANY BACKGROUND**

Veritas Software Corporation ("Veritas"), a Delaware corporation with its principal place of business in Cupertino, California,<sup>4</sup> is in the business of developing, manufacturing, marketing, and selling advanced data storage management products. Its products address needs for protection against data loss and file corruption, rapid recovery after disk or system failure, efficient processing of large files, and systems and back-up management without user interruption.

### **International Expansion; Veritas Ireland**

In the mid- to late-1990s, Veritas expanded its business through corporate acquisitions and the establishment of foreign subsidiaries. In 1997, Veritas acquired and merged with OpenVision Technologies, Inc., thereby acquiring offices in the United Kingdom, Germany, and France. By the end of 1997, Veritas had sales subsidiaries in Canada, Japan, the United Kingdom, Germany, France, Sweden, and the Netherlands. In 1999, with its acquisition of Seagate Software Network and Storage Management Group, Inc.

<sup>1</sup> Unless the context indicates otherwise, all "§" references are to the U.S. Internal Revenue Code of 1986, as amended ("the Code"), and all "Regs. §" references are to the regulations issued thereunder (and set forth in 26 CFR).

<sup>2</sup> 133 T.C. No. 14 (2009).

<sup>3</sup> Regs. §§1.482-1T through 1.482-9T.

<sup>4</sup> On July 2, 2005, Veritas was purchased by Symantec Corporation and became one of Symantec's wholly owned subsidiaries.

(“NSMG”), Veritas became the largest storage software company in the industry.

By 1999, as the Europe, the Middle East, and Africa (“EMEA”) and Asia Pacific and Japan (“APJ”) markets accounted for 92% of the company’s international revenues and 22% of its total revenues, management recognized that further expansion into EMEA and APJ presented an opportunity to increase sales. After evaluating the cost of labor, employment laws, quality of workforce, and tax considerations, management decided to headquarter its EMEA and APJ operations in Ireland. That year, Veritas Operating Corporation (a wholly owned subsidiary of Veritas) formed Veritas Software Holding, Ltd. (VSHL), an Irish company tax resident in Bermuda, which then formed Veritas Software International Ltd. (VSIL), an Irish company tax resident in Ireland that elected to be treated as a disregarded entity for U.S. federal tax purposes (VSHL and VSIL hereinafter collectively referred to as “Veritas Ireland”).

## Cost-Sharing and Sales Agreement

Effective as of November 3, 1999, Veritas and Veritas Ireland entered into a Technology License Agreement (TLA). Pursuant to the TLA, Veritas granted Veritas Ireland the right to use its “Covered Intangibles,”<sup>5</sup> as well as the right to use Veritas trademarks, trade names, and service marks in EMEA and APJ. In exchange, Veritas Ireland agreed to pay royalties to Veritas in amounts specified in the TLA. The TLA, which was amended on three occasions,<sup>6</sup> specified the initial royalty rates, as well as a prepayment

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<sup>5</sup> For purposes of the TLA, “Covered Intangibles” was therein defined as “any and all inventions, patents, copyrights, computer programs (in source and object code form), flow charts, formulae, enhancements, updates, translations, adaptations, information, specifications, designs, process technology, manufacturing requirements, quality control standards, and other intangible rights in existence as of the Effective Date of this Agreement, relating to the design, development, manufacture, production, operation, maintenance and/or repair of any or all of the Products.”

<sup>6</sup> Amendment No. 1 was effective as of Nov. 3, 1999; Amendment No. 2 was effective as of Aug. 1, 2001; and Amendment No.

amount (i.e., a lump-sum buy-in payment). Finally, the TLA provided that the parties “shall adjust the royalty rate prospectively or retrospectively as necessary so that the rate will remain an arm’s-length rate.”

Coterminous with the TLA, Veritas, Veritas Operating Corporation, NSMG, and Veritas Ireland entered into an Agreement for Sharing Research and Development Costs (the “RDA”). Pursuant to the RDA, the cost-sharing participants agreed to pool their resources and research and development (R&D) efforts related to the software products and software manufacturing processes, and thereby share the costs and risks of such R&D on a go-forward basis. The RDA provided Veritas Ireland with:

... the exclusive and perpetual right to manufacture Products utilizing, embodying or incorporating the Covered Intangibles<sup>7</sup> within VERITAS Ireland’s Territory,<sup>8</sup> and the nonexclusive and perpetual right to otherwise utilize the Covered Intangibles worldwide including in the marketing, sale, and licensing of Products utilizing, embodying or incorporating the Covered Intangibles, and in further research into similar technology.

Also effective as of November 3, 1999, Veritas assigned all of its existing sales agreements with its Europe-based sales subsidiaries (i.e., in the United Kingdom, Sweden, Switzerland, France, and Germany) to Veritas Ireland.

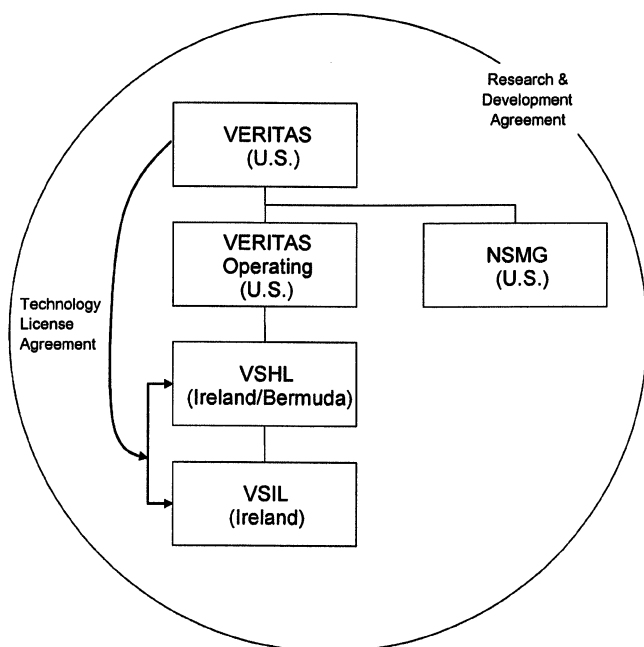
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3 was effective as of July 1, 2002.

<sup>7</sup> For purposes of the RDA, “Covered Intangibles” was therein defined as “any and all inventions, patents, copyrights, computer programs (in source and object code form), flow charts, formulae, enhancements, updates, translations, adaptations, information, specifications, designs, process technology, manufacturing requirements, quality control standards, and other intangible rights arising from or developed as a result of the Research Program.”

The RDA defined “Research Program” as “all software research and development activity and process development activity.”

<sup>8</sup> The RDA defined Veritas Ireland’s territory as “Europe, the Middle East, Africa, Asia, and the Asia Pacific.”



## CASE BACKGROUND

### The 2000 and 2001 Tax Returns; Notice of Deficiency; Tax Court Petition and Pre-Trial Motions and Orders

Veritas timely filed its U.S. federal income tax returns for 2000 and 2001. On its 2000 return, Veritas reported a \$166 million lump-sum buy-in payment received from Veritas Ireland pursuant to the TLA. However, upon receiving updated sales figures and forecast from the subsidiary, Veritas twice amended its 2000 return. Each amendment reduced the lump-sum buy-in payment — first to \$127,011,291, and then to \$117,754,837.

On March 29, 2006, the IRS issued a notice of deficiency based on a report by Dr. Brian C. Becker wherein he concluded, inter alia, that the buy-in payment should have been \$2.5 billion. Dr. Becker calculated this value by employing the market capitalization method, multiple versions of the foregone profits method, and an analysis of Veritas's arm's-length acquisitions. He arrived at a range of values from \$1.9 billion to \$4.0 billion and ultimately settled on the \$2.5 billion figure. In its notice, the IRS determined tax deficiencies of \$703,619,959 and \$53,930,363, and §6662 penalties of \$281,447,984 and \$21,572,145 relating to 2000 and 2001, respectively.

On June 26, 2006, Veritas timely filed its petition with the Tax Court seeking a redetermination of the tax deficiencies and penalties set forth in the IRS notice. On August 25, 2006, the IRS filed its answer, and on August 31, 2006, the IRS filed its amended answer.

In April and May 2007, the parties filed stipulations of settled issues relating to stock-based compensation, technical support services, the §6662 penalties,<sup>9</sup> and the RDA.<sup>10</sup>

In its statement of position filed on September 6, 2007, the IRS explained, “In view of the fact that information is still being collected and analyzed, Respondent cannot state which transfer pricing method(s) he intends to utilize at trial.” On October 11, 2007, in a supplement to its statement of position, the IRS notified the court that it was going to employ the forgone profits method, and that it would not rely on the market capitalization method nor call Dr. Becker as a witness.

On January 11, 2008, Veritas filed a motion for partial summary judgment, contending that: (1) the IRS had abandoned its \$2.5 billion allocation and the transfer pricing methodologies set forth in the March 29, 2006 notice of deficiency; (2) the notice was fundamentally defective; and (3) the IRS's determination was “arbitrary, capricious, and unreasonable.” Veritas further contended that the burden of proof had shifted to the IRS. On February 6, 2008, the IRS filed a notice of objection to the Veritas motion.

On March 7, 2008, the IRS submitted an expert report prepared by Dr. John Hatch, who therein rejected the comparable uncontrolled transaction (CUT) method and the profit split method.<sup>11</sup> Before November 3, 1999 — the effective date of the TLA and the RDA — he argued, Veritas had made several acquisitions of software companies that offered complementary — and, in some cases — competing products. These acquisitions were comparable to the TLA because Veritas received rights pursuant to the acquisitions that were similar to those that Veritas Ireland received pursuant to the TLA, he said. On the basis of his findings, Dr. Hatch characterized the TLA as “akin to a sale” or geographic spinoff (this “akin to a sale” theory will figure prominently) and employed the income method to determine the requisite buy-in payment.

Dr. Hatch did not individually value any of the specific items that were allegedly transferred to Veritas

<sup>9</sup> The parties stipulated the stock-based compensation costs at issue and agreed that the determination of whether such costs must be included in the cost-sharing pool would be “controlled by the final decision, within the meaning of Section 7481 of the Internal Revenue Code (the ‘Code’), in *Xilinx, Inc. and Subsidiaries v. Comr.*, 125 T.C. 37 (2005), *appeals docketed*, No. 06-74246 and 06-74269 (9th Cir., Aug. 30 and Sept. 29, 2006).” In addition, the IRS conceded adjustments relating to technical support services.

<sup>10</sup> The parties established that Veritas Ireland's shares of reasonably anticipated benefits under the RDA were 23.04% in 2000 and 28.47% in 2001.

<sup>11</sup> See Regs. §§1.482-4(c)(1) and 1.482-6, for the respective methods.

Ireland. Instead, he employed an “aggregate” valuation approach based on a three-step analysis. First, he estimated the arm’s-length royalty amounts that would be due in each period (i.e., each calendar year or portion thereof after November 3, 1999) of the TLA. Second, he chose a discount rate to convert estimated future royalty payments into November 1999 dollars. Third, he calculated the buy-in payment as equal to the present value of the royalty payments estimated in Step 1, discounted at the rate determined in Step 2. As such, he concluded that the requisite buy-in payment was \$1.675 billion and that a 22.2% perpetual annual royalty was economically equivalent to the requisite \$1.675 billion payment. In his calculations, Dr. Hatch assumed that the pre-existing intangibles had a perpetual useful life, that 13.7% was the appropriate discount rate, and that 17.91% was Veritas Ireland’s annual compounded growth rate.

On March 21, 2008, the IRS filed an amendment to its amended answer. In accord with Dr. Hatch’s report, the IRS now alleged that the requisite buy-in payment was \$1.675 billion (payable as either a lump-sum payment or a 22.2% perpetual royalty). In addition, the IRS asserted an adjustment relating to a transfer of “certain other intangible rights.” Specifically, the IRS alleged a transfer of access to Veritas’s marketing and R&D teams, as well as Veritas’s trademarks, trade names, customer base, customer lists, distribution channels, and sales agreements (collectively, “the paragraph 9.f items”). In response, Veritas on April 10, 2008, filed its notice of objection, contending that the paragraph 9.f items raised a new matter — because that issue was not described in the notice of deficiency — and required the presentation of new evidence.

On May 2, 2008, the court conducted a hearing on both the Veritas and the IRS motions. In an order issued on June 13, 2008, the court denied Veritas’s motion for partial summary judgment. Although acknowledging that there was a genuine issue with respect to whether the IRS had abandoned the theory and methodology set forth in its notice, the court concluded that Veritas had not shown the notice to be fundamentally defective nor the determination therein to be “arbitrary, capricious, or unreasonable.” With respect to whether the burden of proof shifted to the IRS, the court said a ruling would be premature. The court granted the IRS’s motion for leave to file an amendment to its amended answer and concluded that the notice of deficiency was sufficiently broad to include the paragraph 9.f items. As such, the amendment did not raise a new matter.

On July 1, 2008, the trial commenced. The court first noted that an IRS §482 allocation must be sus-

tained absent a showing of abuse of discretion.<sup>12</sup> Thus, Veritas had to prove that the IRS’s §482 allocation was “arbitrary, capricious, or unreasonable.”<sup>13</sup> If it did so but failed to show that its own proposed allocation met the arm’s-length standard, the court would determine the proper allocation for the buy-in payment.<sup>14</sup>

The court then granted that the IRS’s determination as set forth in its notice of deficiency was presumptively correct.<sup>15</sup> Here, the IRS had set forth two determinations: one in its notice of deficiency, and one in its amendment to its amended answer. Because the court had found that the amendment to the amended answer did not raise a new matter, the presumption of correctness that attached to the IRS’s notice of deficiency carried forward to the revised determination set forth in the amendment to its amended answer.<sup>16</sup> Thus, the court examined the IRS’s determinations separately.

## THE COURT’S OPINION

### IRS’s Notice Determination Found To Be “Arbitrary, Capricious, and Unreasonable”

As noted above, in the notice of deficiency the IRS determined, using Dr. Becker’s valuation, that the requisite buy-in payment to be made by Veritas Ireland was \$2.5 billion. During the trial, the IRS did not call Dr. Becker as a witness, place his report into evidence, or present evidence to support his findings. Instead, relying solely on the later report prepared by Dr. Hatch, the IRS asserted a \$1.675 billion buy-in valuation.

This \$825 million decrease in the IRS’s valuation (with little explanation) was one of several factors the court considered in evaluating the reasonableness of the IRS’s notice determination. The collective factors, the court found, convincingly established that the notice determination was not only “unreasonable,” but also “arbitrary and capricious.” The court noted that Dr. Becker and Dr. Hatch, in calculating their discount rates of 12.8% and 13.7%, respectively, used essen-

<sup>12</sup> *Citing Sundstrand Corp. & Subs. v. Comr.*, 96 T.C. 226, 353 (1991); *Bausch & Lomb, Inc. v. Comr.*, 92 T.C. 525, 582 (1989), *aff’d*, 933 F.2d 1084 (2d Cir. 1991).

<sup>13</sup> *Sundstrand Corp.* at 353–354 (*citing G.D. Searle & Co. v. Comr.*, 88 T.C. 252, 359 (1987), and *Eli Lilly & Co. v. Comr.*, 84 T.C. 996, 1131 (1985), *aff’d in part, rev’d in part, and remanded*, 856 F.2d 855 (7th Cir. 1988)).

<sup>14</sup> *Sundstrand Corp.* at 354.

<sup>15</sup> *Id.* at 353.

<sup>16</sup> *Citing Shea v. Comr.*, 112 T.C. 183 (1999).

tially the same beta (1.4 and 1.42, respectively).<sup>17</sup> However, at trial, Veritas's finance expert had established that 1.935 was the correct beta for the company. Ultimately, Dr. Hatch conceded at trial that his beta of 1.42 "could not, to a reasonable degree of economic certainty, be the correct beta." In essence, Dr. Hatch admitted that both he and Dr. Becker had employed the wrong beta in their calculations.

Accordingly, the court found that the IRS's notice of deficiency was "arbitrary, capricious, and unreasonable."

## **IRS's Revised Determination Also Found "Arbitrary, Capricious, and Unreasonable"**

### **"Akin to a Sale" Theory Was Specious**

As noted above, in its amendment to its amended answer, the IRS contended that Veritas's transfer of pre-existing intangibles was "akin to a sale" and should be evaluated as such. The IRS further contended that because "[t]he assets collectively possess synergies that imbue the whole with greater value than each asset standing alone," it was appropriate to aggregate the controlled transactions, rather than value each asset.

The IRS further argued that, pursuant to Regs. §1.482-1(f)(2)(i)(A),<sup>18</sup> it is authorized to aggregate transactions and treat them as a sale: Transactions may be aggregated if an aggregated approach produces the "most reliable means of determining the arm's length consideration for the controlled transactions." The court was not convinced. It found that the "akin to a sale" theory (i.e., a theory that valued short-lived intangibles as if they had a perpetual life and that took into account intangibles that were subsequently developed (rather than pre-existing)) did not produce the most reliable result. Thus, the court found that, pursuant to Regs. §1.482-1(f)(2)(i)(A), the

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<sup>17</sup> "Beta" is a key component in the formula used to calculate a discount rate. Beta is a measure of the tendency of a security's price to respond to swings in the market. A beta of 1 indicates that the security's price has tended to move in step with the market (i.e., a 1% increase in the market has led to a 1% increase for the security), a beta of less than 1 indicates that the security is less volatile than the market, and a beta greater than 1 indicates that the security is more volatile than the market.

<sup>18</sup> Regs. §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. Generally, transactions will be aggregated only when they involve related products or services, as defined in [Regs. §] 1.6038A-3(c)(7)(vii)."

IRS was not authorized to aggregate the transactions and treat them as a sale.<sup>19</sup>

## **IRS Allocation Took into Account Items Not Transferred or of Little Value**

The parties agreed that certain product intangibles were transferred by Veritas to Veritas Ireland on November 3, 1999, but disagreed about the transfer of certain non-product intangibles (as alleged by the IRS in its amendment to its amended answer).

With respect to distribution channels, the court noted that Veritas had relationships with distributors and resellers prior to the RDA, but that those relationships were weak and had little value; it was not until Veritas Ireland hired a channel manager that the distribution channels were strengthened and maximized. As such, the court concluded that, to the extent Veritas's distribution channels were transferred to Veritas Ireland, they had insignificant value on the date of the transfer.

With respect to the customer lists and customer base, Dr. Hatch agreed that, before the RDA, Veritas lacked the data systems needed to generate accurate and meaningful customer lists, and Veritas's customer base had no value given the company's then-marginal market share and limited presence in EMEA and APJ. The court thus concluded that, to the extent that Veritas's customer lists and customer base were transferred to Veritas Ireland, they also had insignificant value on the date of the transfer.

Finally, with respect to "access to the research and development team," Dr. Hatch testified that his valuation of the buy-in payment did not include access to the R&D team and that access to the R&D team "just was not on my radar screen or anything that I thought of." In addition, Dr. Hatch conceded that if he assumed that the agreement relating to the share of R&D expenses was arm's-length (a fact to which the parties had stipulated), then access to the R&D team would have zero value. With respect to "access to the marketing team," Dr. Hatch testified that he did not value Veritas's marketing team, did not know whether marketing support was provided by Veritas, and had no idea whether the alleged marketing intangibles existed or had been transferred. Thus, the court was bound to conclude that there was insufficient evidence

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<sup>19</sup> Even if the IRS, pursuant to Regs. §1.482-1(f)(2)(i)(A), were authorized to aggregate the transactions, the "akin to a sale" theory may violate Regs. §1.482-1(f)(2)(ii)(A). That regulation provides that "[t]he district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance." The transaction at issue, which certainly had economic substance, was structured as a license of pre-existing intangibles, not a sale of a business.

that access to Veritas' R&D and marketing teams was transferred to Veritas Ireland or had value.<sup>20</sup>

### **IRS Allocation Took into Account Subsequently Developed Intangibles**

Next, the court noted that Dr. Hatch's calculations of the requisite buy-in payment took into account rights to future co-developed intangibles transferred pursuant to the RDA. In that regard, the court noted that Regs. §1.482-7(g)(2) provides in part as follows:

(2) *Pre-existing intangibles.* If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. . . .

The regulation requires a buy-in payment to be made with respect to transfers of "pre-existing intangible property" — no buy-in payment is required for subsequently developed intangibles. The court noted that Dr. Hatch had "unabashedly" taken into account subsequently developed intangibles in calculating the requisite buy-in payment rather than limiting his valuation to pre-existing intangibles. Thus, the court found that the IRS's allocation violated Regs. §1.482-7(g)(2).

### **IRS Employed the Wrong Useful Life, Discount Rate, and Growth Rates**

Having found that the IRS was not authorized to use its "akin to a sale" theory, that its allocation took into account items that were either not transferred or had insignificant value on the date of the transfer, and that its allocation violated Regs. §1.482-7(g)(2), the

court went on to review the useful life, discount rate, and growth rates used by the IRS in its calculation of the requisite buy-in payment.

The court noted that Dr. Hatch, in calculating the buy-in payment, assumed a perpetual useful life for the transferred intangibles, yet acknowledged that "if you had 1999 products that you left untouched, that technology would age and eventually become obsolete" — the pre-existing product intangibles would "wither on the vine" within two to four years without ongoing R&D. Thus, the court found that the useful life of the pre-existing product intangibles was, on average, four years — it was "certainly not perpetual."

With respect to the discount rate used by Dr. Hatch, the court noted that Dr. Hatch had used a "weighted average cost of capital" (WACC)<sup>21</sup> derived under the "capital asset pricing model" (CAPM).<sup>22</sup> Employing the CAPM, he used, as the risk-free rate, the yield on 20-year U.S. Treasury bonds as of March 31, 2000 (without adjustments), and used an "equity risk premium"<sup>23</sup> of 5%. He applied the 5% equity risk premium and the above-mentioned industry beta of 1.42<sup>24</sup> to calculate an applicable discount rate of 13.7%.

The court found several problems with Dr. Hatch's analysis. First, in determining the equity risk premium, Dr. Hatch assumed that the long-term yield for the U.S. stock market was higher than the long-term yield for foreign markets, even though "the literature upon which Hatch relied establishes that there was no difference between the observed risk premium in the U.S. market and the risk premium in foreign markets." This erroneous assumption had led him to an underestimate of the appropriate equity risk premium relating to Veritas Ireland's buy-in payment.

Second, Dr. Hatch used the 20-year U.S. Treasury bond yield as the risk-free rate rather than the 30-day U.S. Treasury bill rate. In that regard, the court noted that the Ibbotson Associates' "Cost of Capital 2000

<sup>20</sup> The court noted that even if such evidence existed, these items would not be taken into account in calculating the requisite buy-in payment because they did not have "substantial value independent of the services of any individual" and thus did not meet the requirements of §936(h)(3)(B) or Regs. §1.482-4(b). The court also noted that "access to research and development team" and "access to marketing team" are not set forth in §936(h)(3)(B) or Regs. §1.482-4(b). To be considered an intangible for §482 purposes, each item must meet the definition of "similar item" and have "substantial value independent of the services of any individual." All that said, the court in Dec. 2008 did note that the Secretary had promulgated temporary regulations (Regs. §§1.482-1T through 1.482-9T) that referenced "assembled workforce." The court also noted that the Obama Administration had proposed to change the law to include "workforce in place" as a §482 intangible in 2009. However, the court was quick to point out that "[f]or the years in issue . . . there was no explicit authorization of the IRS' [s] 'akin to a sale theory' or its inclusion of workforce in place, goodwill, or going-concern values. *Taxpayers are merely required to be compliant, not prescient.*" (Emphasis added.)

<sup>21</sup> The WACC refers to the expected rate of return for a company on the basis of the average portion of debt and equity in the company's capital structure, the current required return on equity (i.e., the cost of equity), and the company's cost of debt.

<sup>22</sup> Estimating the WACC for a company requires estimating the company's cost of equity. The CAPM, which seeks to determine the rate of return for a specific security, is commonly used to estimate a company's cost of equity.

<sup>23</sup> The "equity risk premium" is the expected long-term yield for the stock market less the risk-free rate.

<sup>24</sup> Dr. Hatch employed an industry beta to calculate the discount rate. He had opined that using an industry (rather than a company-specific) beta was preferred because, with respect to an individual company, a beta relating to an earlier period is a very poor predictor of the beta for subsequent periods. Dr. Hatch ultimately admitted, however, that "to a reasonable degree of economic certainty, the beta he used could not have been the correct beta for Veritas as of November 3, 1999."

Yearbook 34” provides as follows: “In all of the beta regressions, the total returns of the S&P 500 are used as the proxy for the market returns. The series used as a proxy for the risk-free asset is the yield on the 30-day T-bill.” On cross-examination, Dr. Hatch acknowledged that he used the wrong risk-free rate. The court therefore found that Dr. Hatch had employed the wrong beta, the wrong equity risk premium, and thus the wrong discount rate with which to calculate Veritas Ireland’s requisite buy-in payment to Veritas.

Finally, the court reviewed the growth rates used by Dr. Hatch. Dr. Hatch had determined that, from 2001 through 2005, Veritas Ireland’s compounded annual growth rate was 17.91%. He projected that Veritas Ireland’s revenues would increase by 13% each year from 2007 through 2010, and beginning January 1, 2011, would increase 7% each year into perpetuity. In that regard, the court noted that Veritas Ireland’s actual growth rate between 2004 and 2006 was 3.75%, 14.16 percentage points lower than — barely more than one-fifth of — Dr. Hatch’s 17.91%. When examined, Dr. Hatch could not provide a plausible explanation for the growth rate he had employed. The court found that “[s]imply put, the growth rate Hatch employed was unreasonable.”

In sum, the court found as follows:

... Veritas Ireland prospered, not because Veritas simply spun off a portion of an established business and transferred valuable intangibles, but because Veritas Ireland employed aggressive salesmanship and savvy marketing, successfully developed the EMEA and APJ markets, and co-developed new products that performed well in those markets. For the foregoing reasons, we conclude that respondent’s allocations set forth in the amendment to amended answer and at trial are arbitrary, capricious, and unreasonable.<sup>25</sup>

Having so found, the Court went on to conclude that the CUT method (with some adjustments) was the best method to evaluate Veritas Ireland’s buy-in payment and, under the CUT method, the royalty that should have been paid by Veritas Ireland for the use

<sup>25</sup> For other cases in which IRS §482 determinations have been found “arbitrary, capricious, or unreasonable,” see *Merck & Co., Inc. v. U.S.*, 24 Cl. Ct. 73 (1991); *Sunstrand Corp. v. Comr.*, 96 T.C. 226 (1991); *Bausch & Lomb Inc. v. Comr.*, 95 T.C. 525 (1989); *G.D. Searle & Co. v. Comr.*, 88 T.C. 252 (1987); *Ciba-Geigy Corp. v. Comr.*, 85 T.C. 172 (1985); *U.S. Steel Corp. v. Comr.*, 617 F.2d 942 (2d Cir., 1980); *Edwards v. Comr.*, 67 T.C. 224 (1976); *American Terrazzo Strip Co. v. Comr.*, 56 T.C. 961 (1971); *PPG Industries, Inc. v. Comr.*, 55 T.C. 928 (1970); *Woodward Governor Co. v. Comr.*, 55 T.C. 56 (1970); *Nat Harrison Assocs., Inc. v. Comr.*, 42 T.C. 601 (1964).

of the pre-existing product intangibles was: 32% in Year 1; 21% in Year 2; 14% in Year 3; and 10% in Year 4.<sup>26</sup> The Court also determined that Veritas Ireland should have paid \$9.6 million for the trademark intangibles. Finally, the Court determined that the appropriate discount rate to be used to determine Veritas Ireland’s buy-in payment should have been 20.47%.

## THE 2009 TEMPORARY COST-SHARING REGULATIONS: REGS. §1.482-1T THROUGH 1.482-9T

As noted above, during the pendency of *Veritas v. Comr.*, the Treasury and IRS issued temporary regulations under §482 relating to cost-sharing arrangements (the “2009 Temporary Regulations”).<sup>27</sup> These temporary regulations followed a set of proposed regulations issued in 2005 (the “2005 Proposed Regulations”).<sup>28</sup> The 2009 Temporary Regulations provide guidance, inter alia, with respect to the transfer of non-product intangibles, discount rates, and certain valuation methodologies.

### Transfers of an R&D Team, Marketing Team, etc.

The 2005 Proposed Regulations described “external contributions” for which compensation was due from other controlled participants, that is, preliminary or contemporaneous transactions. Compensation for a preliminary or contemporaneous transaction corresponded to the “buy-in payment” described in Regs. §1.482-7(g). Under the 2005 Proposed Regulations, an “external contribution” generally consisted of the rights in the “reference transaction” (RT) in any resource or capability reasonably anticipated to contribute to developing cost-shared intangibles. The RT consisted of a transaction, to be designated in the cost-sharing arrangement, affording the perpetual and exclusive rights in the subject resource or capability. While the RT was relevant to valuing the compensation obligation, the controlled participants were not required to actually enter into the RT. Moreover, although the RT assumed perpetual and exclusive rights, proration was required to the extent that the subject resource or capability was reasonably anticipated to contribute both to the cost-sharing activity and to other business activities.

Taxpayers objected to the RT concept as being overly broad. They contended that external contributions included elements such as workforce, goodwill

<sup>26</sup> The rates were rounded to the nearest percentage.

<sup>27</sup> T.D. 9441, 74 Fed. Reg. 340–341 (1/5/09).

<sup>28</sup> REG-144619-02, 70 Fed. Reg. 51116 (8/29/05).

or going concern value, and business opportunity, which either do not constitute intangibles or are not transferred — and therefore are not compensable.

In light of these comments, the 2009 Temporary Regulations replaced the term “external contribution” with the term “platform contribution” and replaced the term “preliminary or contemporaneous transaction” with the term “platform contribution transaction” (PCT).<sup>29</sup> That said, the 2009 Temporary Regulations, like the 2005 Proposed Regulations, do not limit platform contributions that must be in PCTs to the transfer of intangibles defined in §936(h)(3)(B). Thus, to the extent a controlled participant (the “PCT Payee”) contributes the services of its research team for purposes of developing cost shared intangibles, the other controlled participant (the “PCT Payor”) would owe compensation for the services of such team. Further, where there is a combined contribution of research services, intangibles in process, or other resources, capabilities, or rights, the 2009 Temporary Regulations provide for an aggregate valuation that would provide the most reliable measure of an arm’s-length result for the aggregated PCTs and other transactions.

## Discount Rates

Where a present valuation calculation was needed, the 2005 Proposed Regulations provided general guidance that, for purposes of a cost-sharing analysis, a discount rate should be used that most reliably reflects the risk of the particular set of activities or transactions, based on all the information potentially available at the time for which the present value calculation is to be performed.

Taxpayers offered several criticisms of the discount rate guidance provided in the 2005 Proposed Regulations. Some taxpayers concluded that the 2005 Proposed Regulations placed an inappropriate emphasis on a taxpayer’s WACC as a basis for analysis.

The 2009 Temporary Regulations revised and elaborated upon the best method analysis considerations in regard to discount rates, and provided guidance recognizing that the appropriate discount rate may, depending on the facts and circumstances, vary between realistic alternatives and forms of payment. For example, for a licensee, licensing intangibles needed for its operations would ordinarily be less risky — and therefore require a lower discount rate — than entering into a cost-sharing arrangement. Similarly, a royalty computed on a profits base would be more volatile — and therefore require a higher discount rate to discount projected payments to present value — than a royalty computed on a sales base.

<sup>29</sup> Regs. §1.482-9T.

In addition, the 2009 Temporary Regulations eliminated the specific reference to a WACC or to a hurdle rate as “unnecessary,” but without any inference as to whether a WACC or a hurdle rate is an appropriate discount rate or an appropriate starting point in ascertaining a discount rate.

## The Acquisition Price and Market Capitalization Methods

The 2005 Proposed Regulations also included guidance on the “acquisition price” and “market capitalization” methods for evaluating the arm’s-length charge in a PCT. Under the acquisition price method, the arm’s-length charge for a PCT is the adjusted acquisition price — that is, the acquisition price increased by the value of the target’s liabilities on the date of acquisition, and decreased by the value on that date of target’s tangible property and any other resources and capabilities not covered by the PCT. Under the market capitalization method, the arm’s-length charge for a PCT is the adjusted average market capitalization — that is, the average daily market capitalization over the 60 days ending with the date of the PCT, increased by the value of the PCT Payee’s liabilities on such date, and decreased on account of tangible property and any other resources and capabilities of the PCT Payee not covered by the PCT.

Taxpayers questioned the reliability of these methods in light of volatility of stock prices and lack of correlation between stock price and underlying assets, for example, owing to control premiums or economies of integration.

The Treasury and the IRS recognized that, depending on the facts and circumstances of a particular case, those points may need to be taken into account in a best method analysis comparing these methods against the other methods in terms of reliability of results. The 2009 Temporary Regulations retain from the 2005 Proposed Regulations the best method considerations, observing that reliability is reduced under these methods if a substantial portion of the target’s, or PCT Payee’s, non-routine contributions to business activities is not required to be covered by a PCT and, in the case of the market capitalization method, if the facts and circumstances demonstrate the likelihood of a material divergence between the PCT Payee’s average market capitalization and the value of its underlying resources, capabilities, and rights for which reliable adjustments cannot be made. The 2009 Temporary Regulations also provide that proximity in time between the acquisition of the target and the PCT payment is an important comparability factor under the acquisition price method.

**CONCLUSION: IRS's §482  
REALLOCATION IN VERITAS WOULD  
BE PROBLEMATIC UNDER ANY  
REGULATORY REGIME**

In light of the above-described regulatory changes, the question arises: Would *Veritas v. Comr.* have been decided differently if the requisite buy-in payment had been controlled by the 2009 Temporary Regulations? Probably not. The IRS probably still would have abandoned its notice determination and Dr. Becker's report, and Dr. Hatch probably still would have been a less-than-satisfactory witness. And ultimately, the Tax Court probably still would have reached the con-

clusion that the IRS's §482 determinations were "arbitrary, capricious, and unreasonable" in light of its finding that it was the "boots on the ground" that had driven the value of Veritas Ireland's business — that is, to quote the court:

Veritas Ireland prospered, not because Veritas simply spun off a portion of an established business and transferred valuable intangibles, but because Veritas Ireland employed aggressive salesmanship and savvy marketing, successfully developed the EMEA and APJ markets, and co-developed new products that performed well in those markets.