

News from our Tax Group

Tax Court Refutes IRS Cost Sharing Buy-In Valuation Theory: Veritas Software Corp.

In a significant setback for the IRS on December 10, 2009, the United States Tax Court repudiated the IRS position in *Veritas Software Corp.*, widely seen as a test of the current IRS theories concerning the valuation of existing intangible property for the purpose of determining a “buy-in” payment for a cost sharing arrangement (CSA) with a related foreign corporation. Ruling in favor of Veritas, the Tax Court found the IRS position “arbitrary, capricious, and unreasonable,” found its expert analysis “flimsy” and “implausible,” and rejected the underlying basis for the IRS “investor” theory for valuing buy-in payments.

Veritas involved a common pattern for technology companies. Veritas Software Corp. (Veritas US) and its wholly-owned Irish subsidiary (Veritas Ireland) entered into a CSA to develop software. Veritas US transferred certain existing intangible property rights to Veritas Ireland as part of the arrangement. Under the tax rules, in such circumstances Veritas Ireland is required to pay Veritas US a “buy-in” payment. The valuation of the intangible property rights, and thereby the amount of the buy-in payment, is a highly disputed issue and is currently on the IRS Tier I list of issues that warrant close examination.

Veritas US valued the intangible property rights transferred to Veritas Ireland at \$118 million, based primarily on a comparison to licenses of the intangible property to unrelated OEM manufacturers, and set the buy-in payment accordingly. The IRS initially determined the buy-in payment

should be \$2.5 billion, but later reduced it to \$1.68 billion, and asserted that Veritas US owed over \$700 million in taxes for 2000 and 2001.

The IRS determined the buy-in payment under its current uniform litigation and audit position, set forth in an IRS Coordinated Issue Paper: “Section 482 CSA Buy-in Adjustments” issued September 27, 2007 (the “CIP”), and Temporary Regulations Section 1.482-7T, promulgated on January 5, 2009. In general, to determine the buy-in payment, the CIP and the Temporary Regulations rely upon an income method that assumes (i) existing intangible property has a perpetual life, (ii) intangible property later developed under a CSA evolves from and adds to the value of existing intangible property, and (iii) a transfer of intangible property rights under a CSA includes a transfer of rights in all intangible property owned by the taxpayer, including property the tax rules exclude from the buy-in, such as property without significant value independent of an individual’s services, goodwill, and the research and development workforce.

The Tax Court soundly rejected the methodology used by the IRS to determine the buy-in payment, holding (i) Veritas’ software had a useful life (in this case 4 years), (ii) that it was improper for the IRS to have taken into account the income from intangible property later developed under Veritas’ CSA, and (iii) that it was improper for the IRS to have taken into account property excluded from the buy-in under the tax

rules, specifically property without significant value independent of an individual’s services.

The Tax Court also scolded the IRS for applying a new theory to a CSA entered into before the new IRS theory had been announced, stating that taxpayers are “merely required to be compliant, not prescient.”

The IRS is likely to appeal the decision, although any appeal will be delayed while other issues are being resolved. The IRS will also argue that the *Veritas* Court rejected its theory as applied to years before its new Temporary Regulations were effective, and that the investor theory remains applicable to current transactions. The IRS will continue to test its investor theory in Court, but the first case is strongly in favor of the taxpayer position. ■

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