No. 13-60684

In the United States Court of Appeals for the Fifth Circuit

BMC SOFTWARE, INCORPORATED,

Petitioner-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

On Appeal from the United States Tax Court,
District IRS-1, No. 15675-11

BMC'S REPLY BRIEF

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April 28, 2014

CERTIFICATE OF INTERESTED PERSONS

No. 13-60684, *BMC Software, Incorporated v. CIR*

The undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the judges of this Court may evaluate possible disqualification or recusal.

1. **Petitioner-Appellant BMC Software, Inc. ("BMC").** BMC is a wholly-owned subsidiary of BMC Software Finance, Inc., which is wholly-owned by Boxer Parent Company, Inc. Boxer Parent Company, Inc. is a closely-held, non-publicly traded corporation owned by affiliates of Golden Gate Capital Private Equity, Inc., Bain Capital Partners, LLC, Insight Venture Partners, L.P., Westhorpe Investment Pte, Ltd and Elliot Associates, L.P.

2. **Counsel for BMC.** BMC is represented by George M. Gerachis, Gwendolyn J. Samora, and Lina G. Dimachkieh of Vinson & Elkins, L.L.P., 1001 Fannin, Suite 2500, Houston Texas 77002, and by Christine L. Vaughn of Vinson & Elkins L.L.P, 2200 Pennsylvania Avenue, N.W., Suite 500 West, Washington, D.C. 20037.

3. **Respondent-Appellee Commissioner of Internal Revenue.** The Respondent below and Appellee in this Court is the Commissioner of Internal Revenue (the "Commissioner").

4. **Counsel for the Commissioner.** The Commissioner is represented by Ellen Page DelSole and Kathryn Keneally, U.S. Department of Justice, Tax Division, P.O. Box 502, 601 D Street, N.W., Washington DC 20044-0000, by Daniel L. Timmons, Internal Revenue Service, 14th Floor MS 2500 N. 4050 Alpha Road, Dallas, TX 75244-0000, and by William J. Wilkins, Internal Revenue Service, 1111 Constitution Avenue, N.W. Washington, DC 20224-0000.

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes:

Other Authorities:

ARGUMENT

I. THE COMMISSIONER WRONGLY ASSUMES THE CONCLUSION TO THE KEY ISSUE: WHETHER ACCOUNTS RECEIVABLE ESTABLISHED UNDER REV. PROC. 99-32 CREATE RETROACTIVE INDEBTEDNESS FOR ALL PURPOSES.

The Commissioner argues that accounts receivable created almost 20 months after March 31, 2006, the end of the tax year in which BMC received a special cash dividend from its foreign subsidiary, BSEH, under Code section 965, constitute "indebtedness" existing between BMC and BSEH during the section 965(b)(3) Testing Period (which ran from October 3, 2004, to March 31, 2006).[1] The accounts were established and paid in November 2007 pursuant to a Rev. Proc. 99-32 closing agreement (the "99-32 Closing Agreement") wholly unrelated to the section 965 dividend. The sole purpose of this special closing agreement was to permit BMC to adjust its cash accounts following the September 2007 settlement of a transfer pricing audit under section 482.

It is undisputed that BSEH had no actual indebtedness to BMC during the Testing Period; that BMC did not finance any portion of the section 965 dividend; and that when BSEH paid the time-sensitive dividend, the Commissioner had not even proposed any transfer pricing adjustments for Tax Years 2006 and 2007. Yet

[1] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986 ("I.R.C." or the "Code") (26 U.S.C.) or the Treasury regulations promulgated thereunder ("Treas. Reg.") (26 C.F.R.), as amended and in effect during the years at issue. This brief also uses the same record citation forms as used in BMC's Brief of Appellant. *See* Br-App't:1 n.2. And unless otherwise indicated all underscore is added throughout for emphasis.

in his brief ("Br-App'ee"), the Commissioner presumes that the 2007 accounts are "indebtedness" in existence during the Testing Period for all purposes of the Code. Despite conceding that whether—and when—"indebtedness" arises is determined under general federal income tax principles, the Commissioner fails to address them. He simply assumes the conclusion and then repeatedly claims, in *ipse dixit* fashion, that his interpretation prevails.[2] The Commissioner's position contravenes well-settled federal income tax principles, undermines Congress' section 965 incentive, and defies common sense.

A. Whether "Indebtedness" Exists Under Section 965(b)(3) Must Be Determined Under General Federal Income Tax Principles—Not Using Simplistic and Circular Dictionary Definitions.

The question of what constitutes "indebtedness" under section 965(b)(3)—and whether "indebtedness" arose during the Testing Period—cannot be answered here without considering general federal income tax principles. "[T]echnical terms or terms of art used in a statute are presumed to have their technical meaning." 2A SUTHERLAND STATUTORY CONSTRUCTION § 47.29 (7th ed. 2013). The Commissioner has conceded as much, stating that "indebtedness," for purposes of

[2] *See, e.g.*, Br-App'ee:4 ("accounts receivable" established under Rev. Proc. 99-32 constitute an agreement by the taxpayer to "treat amounts that are held by a foreign subsidiary as debt owed to the parent"); Br-App'ee:8 ("accounts receivable reflect[] debt owed from BSEH to taxpayer"); Br-App'ee:14 (closing agreement "established debt as of specified dates within the testing period"); Br-App'ee:29 (under Rev. Proc. 99-32, the "taxpayer must agree such debt was established in the year the payment giving rise to a § 482 adjustment was made").

section 965(b)(3), is defined according to "general Federal income tax principles." EX-10J (Notice 2005-38 § 7.02(a), 2005-1 C.B. 1100, 1111).

Yet the Commissioner contends the Tax Court properly relied on dictionary definitions to resolve the indebtedness issue. Br-App'ee:37-38. The Commissioner reasons (as did the Tax Court) that because *Black's Law Dictionary* defines "debt" to mean "the condition of owing money," and defines an "account receivable" to mean an "account reflecting a balance owed by the debtor," then it inexorably follows that (1) an account receivable, established pursuant to Rev. Proc. 99-32, is debt for all federal income tax purposes, (2) and such debt is deemed to arise years before the account actually exists. Such reasoning ignores the very general federal income tax principles that govern the issue.

B. Because the Commissioner Cannot Prevail Applying General Federal Income Tax Principles on Indebtedness, He Instead Wrongly Dismisses Those Principles as Irrelevant.

This Court and numerous others have recognized that "indebtedness" for federal income tax purposes requires an "existing unconditional and legally enforceable obligation to pay." *Tomlinson v. 1661 Corp.*, 377 F.2d 291, 295 (5th Cir. 1967).[3] This definition is hornbook federal tax law. *See* MERTENS LAW OF

[3] *Accord BB&T Corp. v. United States*, 523 F.3d 461, 475 (4th Cir. 2008); *Noguchi v. Comm'r*, 992 F.2d 226, 227 (9th Cir. 1993); *HGA Cinema Trust v. Comm'r*, 950 F.2d 1357, 1362 (7th Cir. 1991); *First Nat. Co. v. Comm'r*, 289 F.2d 861, 864-65 (6th Cir. 1961); *Comm'r v. McKay Products Corp.*, 178 F.2d 639, 644 (3d Cir. 1949); *Wheat v. United States*, 353 F. Supp. 720, 722 (S.D. Tex. 1973); *John Hancock Life Ins. Co. v. Comm'r*, 141 T.C. No. 1, at 83 (2013).

FEDERAL INCOME TAXATION § 26:4 (Apr. 2014) ("[t]he term 'indebtedness' implies an existing unconditional and legally enforceable obligation to pay"). And under the annual accounting principle, whether indebtedness exists is determined by the facts and circumstances that actually existed at the end of the tax year in question. *Cf. Healy v. Comm'r*, 345 U.S. 278, 284 (1953).

As BMC has explained (*see* Br-App't:23-29), under general federal income tax principles regarding "indebtedness," courts have recognized as follows:

- Although indebtedness necessarily involves an obligation to pay, an obligation to pay is not necessarily indebtedness for federal income tax purposes. *See Deputy v. Du Pont*, 308 U.S. 488, 497 (1940).

- An obligation to pay is not "unconditional" for federal income tax purposes if the timing and amount of payment are uncertain. *See Indeck Energy Servs., Inc. v. Comm'r*, T.C. Memo 2003-101, at 501-03.

- An obligation to pay cannot create indebtedness until the amount to be paid is no longer subject to a contingency. *See Capucilli v. Comm'r*, T.C. Memo 1980-347, *aff'd*, 668 F.2d 138 (2d Cir. 1981).

- An obligation to pay is conditional, and thus does not give rise to "indebtedness" at any time which the obligor is free to back out of the deal. *See Noguchi v. Comm'r*, 992 F.2d 226, 227 (9th Cir. 1993).

- Indebtedness cannot be deemed to have arisen as of a certain date merely because the parties agree that interest will be computed on a particular sum owing as of that date. *See Indeck*, T.C. Memo 2003-101, at 502.

The Commissioner nowhere argues that, applying general federal income tax principles to test for "indebtedness," the 99-32 accounts were "existing unconditional and legally enforceable" obligations to pay at any point in time

during the Testing Period (which closed on March 31, 2006). The Commissioner's silence is an admission that he cannot prevail applying general federal income tax principles. Indeed, the 99-32 accounts indisputably did not exist during the Testing Period, and there could not have been an "existing unconditional and legally enforceable obligation" by BSEH to pay the accounts until, at the earliest, September 25, 2007—the effective date of the 99-32 Closing Agreement. Br-App't:23-28. And one could reasonably argue that no indebtedness could have arisen before November 27, 2007, because before that date BMC and BSEH could have decided not to establish or pay the accounts, with the result being a "deemed capital contribution" from BMC to BSEH. *Id.*:26.

The Commissioner instead argues for the first time on appeal that cases applying the settled federal income tax law definition of indebtedness are irrelevant, or apply only when the Commissioner is challenging whether a transaction involved genuine indebtedness. Br-App'ee:46-50. This Court should decline to consider the Commissioner's new argument. *See St. Tammany Parish v. Fed. Emergency Mgmt. Agency*, 556 F.3d 307, 319 (5th Cir. 2009) (refusing to address argument raised by government, as appellee, for first time on appeal).[4]

[4] Although this Court has permitted an appellee to raise a new statutory argument on appeal, *see Ford-Evans v. United Space Alliance, LLC*, 329 Fed. Appx. 519, 523-24 (5th Cir. 2009), the new argument advanced by the Commissioner is not a statutory one.

Regardless, the Commissioner's argument lacks merit. Although some of the cases discussing the federal income tax test for "indebtedness" involve the Commissioner arguing that indebtedness did not exist under a particular set of facts, these cases do not hold that a different definition of "indebtedness" applies where the taxpayer is arguing no indebtedness arose. And the Commissioner fails to address the critical timing issue of when any indebtedness arises under the annual accounting principle. Nor can general federal income tax principles on "indebtedness" be dismissed as irrelevant here because of any express agreement to treat the Rev. Proc. 99-32 accounts receivable as "indebtedness" for all federal income tax purposes. No such express agreement exists here. *See* Part II.

II. THE 99-32 CLOSING AGREEMENT CONTAINS NO EXPRESS AGREEMENT TO TREAT THE ACCOUNTS RECEIVABLE AS RETROACTIVE INDEBTEDNESS FOR ALL FEDERAL INCOME TAX PURPOSES—OR UNDER SECTION 965(b)(3).

The Commissioner acknowledges that the 99-32 Closing Agreement is a specialized agreement that reflects "closing of a specific matter affecting a taxpayer's tax liability in one or more years." Br-App'ee:34. As such, the 99-32 Closing Agreement must be strictly construed to bind the parties only to the matters expressly agreed upon. *See Smith v. United States*, 850 F.2d 242, 245 (5th Cir. 1988); *accord Ellinger v. United States*, 470 F.3d 1325, 1336 (11th Cir. 2006). "[O]nly matters specifically spelled out in a closing agreement as being resolved will be treated as settled." *Ellinger*, 470 F.3d at 1337. Despite acknowledging that

a court cannot "infer additional terms" not expressly appearing in a limited purpose closing agreement (Br-App'ee:35), the Commissioner then flouts that strict construction principle when he repeatedly proclaims that the parties unambiguously agreed "debt was established as of specified dates within the testing period for federal tax purposes." Br-App'ee:36; *see supra* note 2.

A. The 99-32 Closing Agreement Does Not Expressly Refer to "Indebtedness" or Section 965(b)(3).

The 99-32 Closing Agreement had nothing to do with BMC's section 965 dividend. It arose from the settlement of a wholly unrelated section 482 transfer pricing dispute that was not even proposed as of the end of the tax year (March 31, 2006) in which the section 965 dividend was paid. *See* Br-App't:7-9.

The agreement recites, in the "WHEREAS" clauses, that (a) BMC timely requested relief under section 4 of Rev. Proc. 99-32, and (b) "the parties wish to describe herein the basis on which such relief will be granted." RE-8:758. These recitals are then followed by the caption—"IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes that . . . ."—an introductory phrase mandated by IRS's own procedures (Rev. Proc. 68-16, 1968-1 C.B. 770). *See Vail Resorts, Inc. v. United States*, 2011 WL 2621361, at *6-7 (D. Colo. July 1, 2011).[5]

[5] Because the 99-32 Closing Agreement was based on language mandated by the Commissioner, BMC cannot be considered the "drafter." *See infra* Part III.D.

Next, five numbered paragraphs enumerate the "specific matters" which the parties agreed would form the basis for Rev. Proc. 99-32 relief: (1) paragraph 1 specifies the primary adjustments to the earnings and profits of BSEH for Tax Years 2003-2006, based on the section 482 adjustments agreed to in the Transfer Pricing ("TP") Closing Agreement; (2) paragraph 2 provides that the parties "will establish" interest-bearing accounts receivable as of the dates indicated for each of the primary adjustments; (3) paragraph 3 provides that the accounts receivable to be established shall bear interest at the applicable safe harbor rate from the dates indicated, and specifies how interest will be treated for "U.S. tax purposes;" (4) paragraph 4 deals with foreign tax credits and expressly provides for the treatment of any withholding tax imposed under section 901 of the Code; and (5) paragraph 5 states that the accounts will be paid by "intercompany payment" and provides that "[s]uch payment will be free of the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment," provided the payment is made within 90 days. *See* RE-8:758-59; RE-7.

Not one of the five paragraphs "specifically spells out" any agreement between the parties that the paragraph 2 "accounts receivable" would create "indebtedness" (or "debt" or a "loan") retroactive to the dates before the 99-32 Closing Agreement was effective. The mere reference in paragraph 2 to "accounts receivable" that "will be established" in the future, "as of" dates in the past—solely

for the purposes of computing safe harbor interest—cannot fairly be construed as an unambiguous explicit agreement to treat the accounts receivable as retroactive "indebtedness" for all purposes. *See* Br-App't:27-28, 36-39. Similarly, the caption reciting IRS-mandated boilerplate does not help the Commissioner.[6] The phrase "IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes" is not an express agreement that the accounts to be established under paragraph 2 would constitute retroactive related party indebtedness for all federal income tax purposes—or for purposes of section 965(b)(3). The agreement nowhere mentions section 965.

B. The Absence of Any Express Language in the 99-32 Closing Agreement Regarding "Indebtedness" or Section 965(b)(3) Confirms There Was No Agreement.

The Commissioner downplays the absence of express language dealing with section 965(b)(3), or equating the term "accounts receivable" with "indebtedness," or "debt," or a "loan." Br-App'ee:39. But the absence of such express terms means the 99-32 Closing Agreement does not reflect any explicit agreement that the accounts were indebtedness for all federal income tax purposes. By contrast,

[6] Rev. Proc. 68-16 provides that the taxpayer should separate the "WHEREAS" clauses that introduce the subject matter of the agreement from the numbered paragraphs reflecting the specific matters agreed on, with the caption, "IT IS HEREBY DETERMINED AND AGREED," to be followed by the qualification "for Federal (type of tax) purposes that. . . ." *Vail Resorts*, 2011 WL 2621361, at *6 (quoting Rev. Proc. 68-16). The phrase "for Federal income tax purposes" signifies only that the 99-32 Closing Agreement relates to federal income tax, as opposed to other types of federal taxes (*e.g.*, estate, gift, or excise taxes) that a closing agreement might cover. I.R.C. § 7121(a) (referring to "any internal revenue tax"); Treas. Reg. § 601.102(a).

Paragraph 3 explicitly states the parties' agreement that interest will be deductible by BSEH and includible in taxable income by BMC "for U.S. tax purposes."

Similarly, the absence of any language dealing with section 965(b)(3) is telling in light of paragraph 4, which contemplates that a foreign taxing authority might treat the repayment by BSEH as a dividend and impose a withholding tax. Paragraph 4 provides that, if "any withholding tax is imposed," BMC "may claim a foreign tax credit in respect of such withheld tax to the extent allowable under I.R.C. § 901." Plainly, the parties knew how to address other Code provisions expressly, and they neither expressly addressed section 965 nor expressly stated the accounts receivable would be retroactive indebtedness.

C. There Is No Well-Settled Law Characterizing Rev. Proc. 99-32 Accounts as Indebtedness for All Purposes.

The Commissioner claims that BMC "does not address the well-settled characterization of interest-bearing accounts receivable that must be repaid as indebtedness." Br-App'ee:39. But the Commissioner cites no persuasive authority for this supposed "well-settled characterization." Reliance on the *Black's Law Dictionary* definition of "account receivable" is wholly misplaced. Br-App'ee:38. The term "indebtedness" under section 965(b)(3) is governed by general federal income tax principles, not circular dictionary definitions. *See supra* pp. 2-6.

The Commissioner also cites *National Bank of Newport v. National Herkimer County Bank*, 225 U.S. 178 (1912), to equate "accounts receivable" as "amounts owing . . . on open account." Br-App'ee:38. *National Bank* has nothing to do with whether a Rev. Proc. 99-32 account constitutes "indebtedness" for federal income tax purposes; that case instead addresses whether a transfer of a debtor's accounts receivable constituted a "preference" under the Bankruptcy Act. *See* 225 U.S. at 183-85. And the Supreme Court has already recognized that an "obligation to pay" does not equal indebtedness for federal income tax purposes. *See Deputy v. Du Pont*, 308 U.S. at 497.

Nor does *Long v. Commissioner*, 93 T.C. 5 (1989) hold that accounts established under Rev. Proc. 65-17 (the predecessor to Rev. Proc. 99-32) create debt obligations for all federal income tax purposes. The court in *Long* recognized that the "allocation . . . of income pursuant to section 482 does not create a debt obligation; such an allocation is designed merely to accurately reflect the taxpayer's income." *Id*. at 9 (citing *Eisenberg v. Comm'r*, 78 T.C. 336, 347 (1982)). Although the court observed that "Rev. Proc. 65-17 is the only vehicle by which such an obligation may be created," it did not hold that the mere establishment of accounts receivable would create indebtedness for all federal income tax purposes, much less retroactive indebtedness. Indeed, in *Long* the taxpayer was denied relief under Rev. Proc. 65-17 where it established—but did

not actually pay—the accounts within the 90-day period prescribed in the agreement. *Id*. at 11-12. And the court emphasized that Rev. Proc. 65-17 accounts receivable are the vehicle by which funds can be "transferred to reflect section 482 adjustments without further tax consequences." *Id*. at 9.

D. Neither Treas. Reg. § 1.482-1(g)(3) Nor Rev. Proc. 99-32 Treats Accounts as Indebtedness for All Purposes.

Treasury Regulation § 1.482-1(g)(3) does not support the Commissioner's position equating a 99-32 "account" with "indebtedness." This regulation does not refer to debt or loan treatment at all; it requires that a taxpayer make appropriate conforming "adjustments" to reflect section 482 allocations—which may include (1) treating the allocated amount "as a dividend or a capital contribution," or (2) pursuant to an applicable revenue procedure (*i.e.*, Rev. Proc. 99-32), "repayment of the allocated amount without further income tax consequences."

Nor does Rev. Proc. 99-32 state that accounts established thereunder are treated as loans (or indebtedness) for all federal income tax purposes. The term "account" is used carefully throughout the revenue procedure, and, importantly, "account" is used 68 times versus one single use of "loan." Section 4.01(2), which the Commissioner quotes selectively (Br-App'ee 29-30), provides: "For purposes of section 1.482-2(a)(2)(iii), where applicable, the account shall be considered to be a loan or advance . . . ." Section 4.01(2) thus treats the account as a loan for the

limited purpose of computing safe harbor interest. *See* Br-App't:35, 38-39. If a 99-32 account were indebtedness for all purposes, the Commissioner would have no need to state that the account should be considered a loan "[f]or purposes of section 1.482-2(a)(2)(iii)."

Similarly, the term "debt" appears only 12 times in the revenue procedure. None of these references equates an "account" with "debt." Every reference involves one of two situations: (1) a taxpayer's ability to repay an "account" with a "bona fide debt" obligation instead of cash (*see* section 4.01(4)); or (2) a form of 99-32 relief applicable only to taxpayer-initiated transfer pricing adjustments—not involved here—permitting prepayments by "offset" against a "bona fide debt" between the U.S. and foreign affiliates (*see* section 4.02). The careful use of the terms "account," "loan," and "debt" in Rev. Proc. 99-32 confirms that a 99-32 "account" is not "debt" for all purposes. Had the Commissioner intended this result, he would have stated so directly in Rev. Proc. 99-32.

E. The Commissioner Did Not Craft an Express Agreement for "Indebtedness" Under Section 965(b)(3).

In Advice Memorandum 2008-010 (September 15, 2008), the Commissioner explained (for the first time) his legal position relating to "[w]hether an account receivable established by an election to apply Rev. Proc. 99-32 constitutes related party indebtedness under I.R.C. § 965(b)(3)," and recommended that "all closing

agreements under Rev. Proc. 99-32 covering a taxable year in which the taxpayer elected the benefit of I.R.C. § 965 include language confirming that the account receivable established in the closing agreement constitutes related party indebtedness" under section 965(b)(3). EX-13J:449. The express language the Commissioner recommended for inclusion in future closing agreements provides:

> Any intercompany account receivable established by the taxpayer pursuant to this closing agreement will be considered related-party indebtedness for all purposes of the I.R.C. including, but not limited to, section 965(b)(3).

EX-13J:451. No such express language was included in BMC's 99-32 Closing Agreement, which became effective in September 2007.

The court's decision in *Ellinger* is instructive. There, the question was (a) whether certain monetary transfers made by Aberdeen (a corporation owned by Ellinger) to GlobalTel and ProMail (also owned by Ellinger) were bona fide loans or indebtedness, as originally characterized in Aberdeen's records, or (b) whether the transfers constituted capital contributions as later recharacterized by Aberdeen. The IRS disputed the recharacterization, and after a series of negotiations, entered into three closing agreements. In the agreement with Aberdeen, the parties expressly agreed that the year-end recharacterization of the transfers as capital contributions would be disregarded and that the transfers "constitute[d] genuine indebtedness owed by GlobalTel and ProMail to the taxpayer." 470 F.3d at 1330.

In the agreements with GlobalTel and ProMail, while the parties agreed the year-end recharacterization of the transfers would be disregarded, those agreements "failed to refer explicitly to the transfers from Aberdeen as 'genuine indebtedness.'" *Id.*

Ellinger later claimed a refund based on his status as a shareholder of GlobalTel and ProMail, arguing that the original transfers established genuine indebtedness. *Id.* at 1333. Ellinger sought to rely on the express "indebtedness" language in the Aberdeen closing agreement to argue that "[t]he traditional indicia of bona fide indebtedness became irrelevant when the government and the parties executed the closing agreements." 470 F.3d at 1335. The court rejected Ellinger's argument, explaining that "the problem . . . is that the reference to the transfers as debts only appears in the closing agreement between the IRS and Aberdeen; the closing agreements between the IRS and GlobalTel and ProMail, on the other hand, are devoid of any such language." *Id.* at 1336. Because the transfers did not qualify as debt under the applicable general federal income tax principles, Ellinger's refund claim was denied. *Id.* at 1339.

Just as the Eleventh Circuit rejected the taxpayer's argument in *Ellinger* that the closing agreement language rendered "traditional indicia" of indebtedness irrelevant, this Court should reject the Commissioner's argument that general principles of federal income tax are irrelevant to the question whether the Rev.

Proc. 99-32 accounts receivable constitute "indebtedness," let alone retroactive "indebtedness," under section 965(b)(3). There is no express agreement in the 99-32 Closing Agreement that the accounts establish "indebtedness" (retroactive or otherwise), and none can be implied.

III. THE COMMISSIONER MISCONSTRUES PARAGRAPH 5 OF THE 99-32 CLOSING AGREEMENT—WHICH PERMITTED BMC TO SQUARE ITS ACCOUNTS WITH NO FURTHER FEDERAL INCOME TAX CONSEQUENCES.

A. Paragraph 5 Must Be Construed in Light of Rev. Proc. 99-32 and Consistent With Treas. Reg. § 1.482-1(g)(3)(i).

The Commissioner not only implies an agreed "debt" term not expressly spelled out in the closing agreement, he misconstrues paragraph 5, which states:

> BSEH will pay the account receivable, including interest thereon, by intercompany payment. Such payment will be free of the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment; *provided*, the payment of the balance of the account, after taking into consideration any prepayment pursuant to section 4.02 of Rev. Proc. 99-32, is made within 90 days after executing of this closing agreement on behalf of the Commissioner.

RE-8:758-59. Paragraph 5 must be construed consistent with the surrounding regulatory context, including Treas. Reg. § 1.482-1(g)(3), which is the regulation, entitled to deference, authorizing the Commissioner to issue Rev. Proc. 99-32. *See Pennzoil Co. v. F.E.R.C.*, 645 F.2d 360, 388-89 (5th Cir. 1981) (interstate gas contracts should be interpreted in federal regulatory context).

Treasury Regulation § 1.482-1(g)(3)(i) plainly states appropriate adjustments "must be made to conform a taxpayer's accounts to reflect allocations made under section 482," and that "[s]uch adjustments" may include:

> [1] the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, [2] in appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see § 601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

Treasury Regulation § 1.482-1(g)(3)(i) provides for two categories of conforming or secondary adjustments: First, if the taxpayer does not elect relief under the applicable revenue procedure, then the taxpayer's secondary adjustment must take the form of either a capital contribution or a dividend, as appropriate. That is the "default" conforming adjustment. Second, if the taxpayer elects relief under the "applicable revenue procedure," that relief is the alternative secondary adjustment under Treas. Reg. § 1.482-1(g)(3)(i).

Revenue Procedure 99-32 is the "applicable revenue procedure" under Treas. Reg. § 1.482-1(g)(3)(i). It provides for repayment of the allocated sum via an account that is to be "free" of federal income tax consequences. Therefore, paragraph 5 of the 99-32 Closing Agreement—which uses language expressly required by Rev. Proc. 99-32—must be construed consistently with this authorizing regulation, which in turn requires that such applicable revenue procedure permit repayment "without further income tax consequences."

Accordingly, paragraph 5 of the 99-32 Closing Agreement must be construed to include all secondary adjustments in Treas. Reg. § 1.482-1(g)(3)(i)—both the default secondary adjustment (capital contribution or dividend) and the alternative secondary adjustment under Rev. Proc. 99-32, which involves establishing and paying accounts. And if "tax consequences" would result from the alternative Rev. Proc. 99-32 secondary adjustment, paragraph 5 provides that payment also will be "free" of those tax consequences.

The case law supports this plain reading of paragraph 5. In *Long*, the court stated that an account receivable established under Rev. Proc. 65-17 is the vehicle allowing the taxpayer to transfer funds "to reflect section 482 adjustments without further tax consequences." 93 T.C. at 9. Similarly, the court recognized that Rev. Proc. 65-17 allows "financial records to be adjusted to reflect changes in taxable income," and that "accounts receivable" provided for therein are "but a means to an end, the end being reconciliation of economic realities to tax consequences" that were already imposed as a result of the section 482 adjustments. *Id.* at 11.

BMC's interpretation of paragraph 5 is likewise supported by the testimony of Randell Price, who negotiated the 99-32 Closing Agreement for BMC. Based on his experience with other closing agreements, he was well-qualified to testify about the operation and purpose of Rev. Proc. 99-32, as well as the technical terms in the 99-32 Closing Agreement. *See* Br-App't:41-43. He testified, consistent

with both the regulatory context surrounding the 99-32 Closing Agreement and the language of paragraph 5, that the whole purpose of electing relief under Rev. Proc. 99-32 was to enable BMC to square its cash accounts without any further federal income tax consequences in any year, so that after squaring its accounts BMC would be in the same position it would have been had its original returns included the transfer pricing adjustments reflected by the settlement. RE-6:47-48, 55, 65-66, 71-72, 76-77. The Commissioner adduced no controverting evidence.

B. The Commissioner Seeks to Rewrite Paragraph 5 of the 99-32 Closing Agreement and Treas. Reg. § 1.482-1(g)(3)(i).

The Commissioner says that the "statement authorizing the Commissioner to provide procedures for 'repayment of the allocated amount without further tax consequences' is permissive." Br-App'ee:63. While true, this is not dispositive. Where the conforming adjustments mandated by Treas. Reg. §1.482-1(g)(3)(i) are the subject of a revenue procedure, the regulation states that the "applicable revenue procedures" that the Commissioner provides will permit "repayment of the allocated amount without further income tax consequences." The Commissioner is not required to adopt a revenue procedure providing for an alternative conforming adjustment, but, where he does, it must provide for "repayment of the allocated amount without further income tax consequences."

The Commissioner also asks this Court to disregard the broad language of paragraph 5—and therefore construe it inconsistently with Treas. Reg. § 1.482-1(g)(3)(i). The Commissioner reads paragraph 5 to provide that BSEH's payment of the accounts would only be "free of the federal income tax consequences of the secondary adjustments, which, in the absence of the Rev. Proc. 99-32 agreement, would have followed from the primary § 482 adjustments." Br-App'ee:52. Under the Commissioner's interpretation, paragraph 5 provides only that "the payment of the accounts receivable would be free of the federal income tax consequences that otherwise would follow from the default (capital contribution) treatment of the excess royalties taxpayer paid to BSEH." *Id.*

Paragraph 5 is not so limited. It does not provide that only tax consequences flowing from the "default" (capital contribution) secondary adjustment would be avoided. Paragraph 5 provides that BSEH's payment of the accounts receivable (*i.e.*, the secondary adjustment provided by Rev. Proc. 99-32) will be "free of the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment." Nothing in the language of paragraph 5 limits the "secondary adjustment***s***"—plural—that are to be free of "Federal income tax consequenc***es***"—plural—to the single adjustment (the default capital contribution) and single tax consequence (dividend treatment) posited by the Commissioner.

The Commissioner erroneously attempts to dismiss paragraph 5's use of the plural, both with respect to "secondary adjustments," and "tax consequences," on the basis that there were multiple primary adjustments. Br-App'ee:53 n.11. Paragraph 5, however, uses "primary adjustment" in the singular, and states that payment by BSEH would be "free of the federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment." As to each "primary adjustment," paragraph 5 provides that payment of the account is free from the "federal income tax consequences of the secondary adjustments" that would otherwise flow from that primary adjustment.

C. The Commissioner's Reliance on Closing Agreement Cases That Do Not Include an Express Provision (Like Paragraph 5) Prohibiting Further Tax Consequences Is Misplaced.

The Commissioner argues that, "where a closing agreement reflects an agreement for treatment of certain specific items but does not entirely resolve the taxpayer's tax liability, penalties, and interest for a given period, the taxpayer is bound to the terms provided for in the agreement for all federal tax purposes, unless the agreement specifies otherwise." Br-App'ee:53-54. He contends that "other collateral tax consequences generally apply in accordance with the law." *Id.*:54 (discussing *Smith v. United States*, 850 F.2d at 245 (holding that the IRS's

claim for interest/penalties was not barred by a closing agreement that determined taxpayer's losses but did not finally determine tax liability)).[7]

BMC does not "misperceive" the law relating to closing agreements (Br-App'ee:53) or the import of the decisions cited by the Commissioner at pp. 53-56 of his brief. BMC cited many of these same decisions in discussing the principles governing the construction of a limited purpose closing agreement. *See* Br-App't:30-33. *Smith* and these other cases stand for the proposition (also relied on by BMC) that closing agreements must be "strictly construed" to bind the parties only to the matters expressly agreed upon. *See* Br-App't:32-33; *see supra* pp. 6-7. The Commissioner selectively emphasizes this proposition when talking about paragraph 5 of the 99-32 Closing Agreement; he then ignores this strict construction principle by arguing that paragraph 2 contains an <u>implicit</u> agreement that the accounts receivable create retroactive indebtedness for all federal income tax purposes. *See* Br-App'ee:35-40.

Even focusing solely on paragraph 5, however, and whether it precludes the Commissioner from imposing further tax consequences under section 965(b)(3), *Smith* and other similar cases, *see* note 7, do not support the Commissioner. None

[7] The IRS also cites similar cases like *United States v. Nat'l Steel Corp.*, 75 F.3d 1146, 1151-52 (7th Cir. 1996), *In re Spendthrift Farm, Inc.*, 931 F.2d 405 (6th Cir. 1991), *Ewing v. United States*, 914 F.2d 499, 505 (4th Cir. 1990), *Bush v. United* States, 84 Fed. Cl. 90, 95 (2008), *Estate of Magarian v. Comm'r*, 97 T.C. 1 at 6-7 (1991), and *Shelton v. United States*, 2008 WL 4346134, at *6 (Fed. Cl. 2008). *See* Br-App'ee:55-56.

of these cases involved a provision, as in paragraph 5, stating that payment of the amounts required by the agreement would be "free" of Federal income tax consequences of the secondary adjustments that would otherwise result from the primary (transfer pricing) adjustment. None of the cases involved a Rev. Proc. 99-32 closing agreement, the very purpose of which is to permit the taxpayer to square his account "without further tax consequences."

Nor does *Schering v. Comm'r*, 69 T.C. 579 (1978) permit the Commissioner to impose further adverse tax consequences on BMC. *Schering* recognizes that Rev. Proc. 65-17 is an equitable taxpayer relief provision, the primary purpose of which "was to permit repatriation of amounts reallocated to a [corporate taxpayer] without such repatriation triggering an additional tax under section 301 as a distribution of property by the subsidiary to the parent." *Id.* at 597. *Schering* does not hold that a taxpayer's repatriation of a reallocated amount pursuant to Rev. Proc. 65-17 can "trigger[] an additional tax" under some other Code provision.

Schering held that the accounts receivable created under the Rev. Proc. 65-17 closing agreement did not preclude the taxpayer from claiming a "credit"—*i.e.*, a tax benefit—for the tax withheld by the foreign entity on the amount repatriated. *Schering* rejected the Commissioner's arguments that (a) the accounts constituted debt for all purposes, and (b) the closing agreement language, providing that repayment would be "free of further Federal income tax consequences," expressly

precluded the taxpayer from claiming a benefit under another Code section. *Id.* at 591-95. The court in *Schering* held that Rev. Proc. 65-17, because of its equitable nature, should not be construed "to deny the United States taxpayer a benefit available to it under other sections of the Code." *Id.* at 597. That is precisely what the Commissioner seeks to do here—construe Rev. Proc. 99-32 to deny BMC a benefit it claimed *years earlier* under another Code provision (*i.e.*, under section 965). The Commissioner's position turns equity on its head.

D. BMC Prevails Regardless of Whether Paragraph 5 Is Unambiguous or Ambiguous.

The Commissioner claims that BMC's Mr. Price "drafted the agreement," such that "if the Court should find it ambiguous," it should be construed against the taxpayer. Br-App'ee:61. The Commissioner's argument is refuted by the record. The 99-32 Closing Agreement incorporates Rev. Proc. 99-32 itself, and the precise language in paragraph 5 was lifted verbatim from the revenue procedure—which the Commissioner drafted (not BMC)—as were the other provisions in the numbered paragraphs. *See* RE-6:49-51; *see also* Rev. Proc. 99-32 § 5.01(4)(e). Under these circumstances, the 99-32 Closing Agreement cannot be construed against BMC, because BMC was not the "drafter." If anything, any ambiguity in the agreement must be construed against the Commissioner.

The Commissioner also contends that, based on Mr. Price's review of Notice 2005-64, Mr. Price should have been aware of the Commissioner's position (1) that accounts receivable established years after the Testing Period would create retroactive indebtedness for section 965(b)(3) purposes; and (2) that paragraph 5 of the 99-32 Closing Agreement would not preclude imposition of such retroactive tax consequences. Br-App'ee:52-62. This argument lacks merit. Notice 2005-64 (a 21-page document) contained one sentence concluding, with no analysis or reference to timing: "Accounts payable established under Rev. Proc. 99-32 . . . in connection with section 482 adjustments are to be treated as indebtedness for purposes of section 965(b)(3)."[8]

Neither of the parties negotiating the 99-32 Closing Agreement (BMC's Mr. Price and the IRS's Mr. Payne) discussed section 965 of the Code or the single sentence in Notice 2005-64, which in any event did not assert (as the IRS does now) that accounts receivable established and paid in 2007 create retroactive related party indebtedness under section 965(b)(3). Nothing in Notice 2005-64 indicates that accounts receivable established after the close of the Testing Period could be deemed indebtedness existing during the Testing Period. The IRS did not

[8] Of course, no such express language appears in BMC's 99-32 Closing Agreement. Moreover, the Commissioner has stipulated that Notice 2005-64 did not amend Rev. Proc. 99-32 and thus was not part of the 99-32 Closing Agreement. Br-App't:36; RE-4:11(¶33). And, as the Commissioner concedes, IRS notices are not entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). Br-App'ee:62 n.15.

make that radical position publicly known until it issued Advice Memorandum 2008-010 in September 2008 (well after BMC executed the 99-32 Closing Agreement). Moreover, although Mr. Price reviewed Notice 2005-64 back in 2005-2006, when he prepared BMC's section 965 dividend repatriation plan, he did not recall focusing (and had no reason to focus) on the single sentence in Notice 2005-64 because at that time no indebtedness existed between BMC and BSEH, and no transfer pricing adjustments had even been proposed for Tax Years 2005 or 2006 (the years within the Testing Period). RE-6:39-41.

To prevail, the Commissioner must convince this Court both (1) that the parties explicitly and unambiguously agreed in the 99-32 Closing Agreement that the accounts receivable created pursuant to paragraph 2 would be "indebtedness" for all federal income tax purposes retroactive to the section 965(b)(3) Testing Period; and (2) that paragraph 5 of the 99-32 Closing Agreement is unambiguous and protects BMC only from a single "tax consequence"—namely, treatment of the returned funds as fully taxable dividends in Tax Year 2008 (*see* Br-App'ee:60). The Commissioner cannot prevail on either argument, much less both arguments.

BMC, by contrast, prevails if the Commissioner is incorrect on either argument. If the Court holds that the 99-32 Closing Agreement does not expressly address the indebtedness issue, then whether the accounts create retroactive indebtedness must be determined under general federal income tax principles.

However, as explained, *see supra* pp. 3-5, the Commissioner nowhere argues that he could prevail applying those principles. Likewise, BMC prevails if the Court holds that BMC's interpretation of paragraph 5 is the only reasonable one—or if paragraph 5 is at least ambiguous. If paragraph 5 is in any way ambiguous (*i.e.*, subject to two reasonable interpretations), BMC prevails based on Mr. Price's uncontradicted testimony regarding the parties' intent. *See* Br-App't:52-55.

IV. THE COMMISSIONER FAILS TO JUSTIFY THE ABSURD AND INEQUITABLE RESULT IN THIS CASE.

Responding to a congressional incentive to jump-start the U.S. economy, BMC repatriated $721,081,018 from BSEH before March 31, 2006. BMC determined this amount qualified for the section 965 dividends-received deduction ("DRD") based on the facts that existed on March 31, 2006—which it had to do given the time-sensitive nature of the one-time section 965 incentive. On that date, BMC had no related party indebtedness, and the Commissioner had not proposed any transfer pricing adjustments for any year falling within the Testing Period.

As a result of section 482 allocations agreed to in the TP Closing Agreement almost two years later, BMC recognized additional taxable income totaling $101,560,047 in Tax Years 2003 through 2006 and paid taxes and interest on that sum. RE-5:3(¶67). No one disputes that the 99-32 Closing Agreement permitted BMC to repatriate the entire $101,560,047 (the primary adjustments) without any

tax consequences in Tax Year 2008 (the year in which the funds were moved). *See* Br-App'ee:60, 67. Indeed, the Commissioner agrees that the purpose of Treas. Reg. § 1.482-1(g)(3)(i) and Rev. Proc. 99-32 is to prevent "the same money," *i.e.*, section 482 income reallocations, from "being taxed twice." Br-App'ee:28.

Yet the Commissioner nowhere explains why it is reasonable, under contract interpretation principles, to conclude the parties agreed in the 99-32 Closing Agreement that the Commissioner could do indirectly, in Tax Year 2006—by retroactively reducing BMC's section 965 DRD—what the Commissioner admits he could not do directly. As to $43.4 million of the $101,560,047 that the parties indisputably agreed could be repatriated "tax-free" in Tax Year 2008, 85% of that "same" amount is in fact "being taxed twice," with BMC facing a $12.9 million tax consequence. Contracts should not be construed to produce such absurd results. *See Beanstalk Group, Inc. v. Am Gen. Corp.*, 283 F.3d 856, 860 (7th Cir. 2002).

The Commissioner concedes that section 965(b)(3) "ensures that a dividend funded by a U.S. shareholder, directly or indirectly, and that thus does not create a net repatriation of funds, is ineligible for the benefits accorded by § 965." Br-App'ee:32. In this case, no intercompany indebtedness actually existed between BMC and BSEH during the Testing Period. Nor did BMC finance the section 965 dividend, directly or indirectly; the "net" repatriation of funds to the U.S. was the total dividends of $721,081,018 paid by BSEH. *See* Br-App't:58. BSEH had more

than adequate cash and other liquid assets to pay the full $721,081,018 in Tax Year 2006, even taking into account the $101,560,047 in section 482 adjustments (which decreased BSEH's income) later agreed to in the TP Closing Agreement. RE-6:69-71. The underlying purpose of section 965(b)(3) is not implicated here.[9]

The Commissioner nonetheless suggests that BMC used an "aggressive transfer pricing" strategy in so-called "tax-haven" jurisdictions in his misguided effort to insinuate some sort of anti-avoidance purpose to BMC. *See, e.g.*, Br-App'ee:27. Such contentions are spurious, as is his contention that "[t]axpayer did not dispute the § 482 adjustments." *Id.* BMC vigorously contested the section 482 adjustments (originally proposed only for Tax Years 2002 and 2003), and the Commissioner conceded a substantial majority of the proposed transfer pricing adjustments in the settlement. *See* RE-4:12-18(¶¶39-50); EX-22J; EX-23J. Appellee's insinuations that BMC admitted to some sort of "wrongdoing" under the TP Closing Agreement are baseless—and are belied by the fact the Commissioner never sought any penalties attributable to his section 482 adjustments, granted Rev. Proc. 99-32 relief, and stipulated that BMC had no anti-avoidance purpose in this case. RE-7:746(¶4); RE-4:15(¶44), 21(¶58).

[9] Although BMC is not arguing on appeal that a taxpayer must subjectively "intend" to avoid section 965(b)(3), BMC is arguing—and asserted in its opening brief—that absent actual related party debt within the Testing Period, any non-debt transaction must actually have financed the payment of the dividend for section 965(b)(3) to apply. *See* Br-App't:56-58.

The Commissioner has no justification—legal or otherwise—for the inequitable and absurd result reached by the Tax Court in this case.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 32(a)

Pursuant to 5th Cir. R. 32.2 and .3, the undersigned certifies that this brief complies with the type-volume limitations of FED. R. APP. P. 32(a)(7)(B).

1. Exclusive of the exempted portions in 5th Cir. R. 32.2 and FED. R. APP. P. 32(a)(7)(B)(iii), the Brief contains 6,989 words.

2. The Brief has been prepared: in proportionally spaced typeface using Microsoft Word 2010, in Times New Roman 14 pt. (except for footnote text, which is 12 pt. pursuant to 5th Cir. R. 32.1).

3. The undersigned understands a material misrepresentation in completing this certificate, or circumvention of the type-volume limits in FED. R. APP. P. 32(a)(7)(B), may result in the Court's striking the Brief and imposing sanctions against the person signing the Brief.

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US 2447361v.4