

**US TAX COURT
RECEIVED**

**MAY 4 2020
6:56 PM**

SD



**US TAX COURT
eFILED**

MAY 4 2020

WESTERN DIGITAL CORPORATION AND
SUBSIDIARIES,

Petitioner,

ELECTRONICALLY FILED

v.

Docket No. 18984-18

COMMISSIONER OF INTERNAL REVENUE,

Respondent

RESPONDENT'S FIRST AMENDMENT TO ANSWER

SERVED May 04 2020

UNITED STATES TAX COURT

WESTERN DIGITAL CORPORATION)	
AND SUBSIDIARIES,)	
)	
Petitioner,)	
)	Docket No. 18984-18
v.)	
)	Judge Patrick J. Urda
COMMISSIONER OF INTERNAL)	
REVENUE,)	Filed Electronically
)	
Respondent		

AMENDMENT TO ANSWER

RESPONDENT, in Amendment to Answer to the Petition filed in the above-entitled case, strikes from said Answer paragraph 7 and the prayer and inserts in lieu thereof the following:

7. FURTHER ANSWERING THE PETITION, respondent alleges:
 - a. Respondent provided to petitioner respondent's intended motion for leave to file an amendment to answer and accompanying Amendment to Answer on April 30, 2020. After review, petitioner proposed that it would consent in writing to the filing of the Amendment to Answer pursuant to Tax Court Rule 41(a), which allows for amendment of a pleading by written consent of the adverse party.

- b. On May 4, 2020, petitioner emailed its written consent for filing of the Amendment to Answer which is attached as Exhibit A.
8. Respondent further alleges:
- a. Petitioner is liable for the 40% gross valuation misstatement penalty under Internal Revenue Code sections 6662(b)(3) and 6662(e)(1)(B) as modified by Code section 6662(h) related to the adjustment with respect to the TLA. The amount of the penalty for the 2008 taxable year is \$192,546,002.
 - b. The adjustment at issue for the 2008 taxable year exceeds the \$20,000,000 threshold under Code section 6662(h)(2)(A)(iii).
 - c. Petitioner did not use a specified method in a reasonable manner as required under Code section 6662(e)(3)(B)(i)(I).
 - i. During the audit, respondent requested that petitioner explain and describe the intangible property licensed in the TLA and provide the valuation study.
 - ii. Petitioner provided a report prepared by KPMG entitled “Analysis and Valuation of Technological Intellectual Property in Western Digital Hard Disk Drives” (the “KPMG Report”).
 - iii. The KPMG Report relied on a faulty and unreliable analysis about head gimbal assembly manufacturing costs to

conclude that its manufacturing efficiencies were the sole source of petitioner's non-routine profits.

iv. Petitioner, relying on the KPMG Report, concluded that \$140,900,000 was sufficient to cover anticipated royalties for the initial 4-year term of the TLA. This amount did not cover royalties for actual sales for even half of the projected period.

v. The size of the net transfer pricing adjustment for the 2008 taxable year, is nearly ten times the amount of the value in the KPMG Report.

vi. The KPMG Report lacked any discussion regarding the profit potential of the TLA or related transactions.

vii. The KPMG Report does not describe the potential applicability of any alternative methods considered.

viii. The KPMG Report was not prepared to protect petitioner against penalties. The engagement letter between petitioner and KPMG for the KPMG Report stated that "[w]e do not anticipate that the written tax advice provided under this engagement letter will . . . be used by WDC for purposes of avoiding penalties."

d. Petitioner did not provide appropriate documentation as required under Code sections 6662(e)(3)(B)(i)(II) and (III).

i. At the time petitioner filed its tax return for the 2008 taxable year, petitioner did not have documentation to support its transfer price for intangibles licensed under the TLA other than the KPMG Report.

ii. The KPMG Report does not satisfy the documentation requirements of Treas. Reg. § 1.6662-6(d)(2)(iii).

iii. The KPMG Report is not dated or signed.

iv. The KPMG Report does not indicate whether it was prepared for Code section 6662 purposes or prepared in accordance with the best method rule in regulation section 1.482-1(c).

v. The KPMG Report fails to describe any alternative methods considered.

9. Respondent further alleges in the alternative that petitioner is liable for the 20% substantial valuation misstatement penalty under Code sections 6662(b)(3) and (e)(1)(B). The amount of the penalty for the 2008 taxable year is \$96,273,001.

- a. The adjustments at issue exceed the \$5,000,000 threshold under Code section 6662(e)(1)(B)(ii).
 - b. Petitioner did not use a specified method in a reasonable manner as required under Code section 6662(e)(3)(B)(i)(I).
 - i. Paragraphs 8.c.i.-viii. are incorporated here by reference.
 - c. Petitioner did not provide appropriate documentation as required under Code sections 6662(e)(3)(B)(i)(II) and (III).
 - i. Paragraphs 8.d.i.-v. are incorporated here by reference.
10. Respondent further alleges in the alternative that petitioner is liable for the 20% penalty for negligence or disregard of rules or regulations under Code sections 6662(b)(1) and (c). The amount of the penalty for the 2008 taxable year is \$96,273,001.
- a. Petitioner did not make a reasonable attempt to comply with the provisions of the Code or its regulations. Petitioner acted carelessly, recklessly, and intentionally disregarded the provisions of the Code and regulations.
 - b. Petitioner's transfer price for the intangibles licensed under the TLA resulted in hundreds of millions of dollars in revenue being shifted offshore even though the basic functions/activities performed by WDT, WDF, WDTh, and WDM generally remained the same

before and after the effective date of the TLA. Such a result was “too good to be true” under the circumstances.

c. Petitioner’s reliance on the KPMG Report was unreasonable.

i. Paragraphs 8.c.i.-viii. are incorporated here by reference.

d. Petitioner did not reasonably rely on advice from a tax professional to protect itself from penalties.

i. Paragraph 8.c.viii. is incorporated here by reference.

11. Respondent further alleges in the alternative that petitioner is liable for the 20% penalty for substantial understatement of income tax under Code sections 6662(b)(2) and (d). The amount of the penalty for the 2008 taxable year is \$96,273,001.

a. The tax deficiency related to the TLA adjustments is approximately \$481.4 million for the 2008 taxable year.

b. The tax deficiency for the 2008 taxable year exceeds \$10,000,000.

c. Petitioner did not have a reasonable basis for its transfer price for the intangibles licensed under the TLA.

d. Petitioner does not have any substantial authority upon which it can rely upon to reduce the substantial understatement of income tax penalty.

12. The Notice adjusts the “lump-sum pre-payment” under the TLA. If the Court determines that the adjustment should be in the form of an adjustment to annual royalties instead of an adjustment to the lump-sum pre-payment, respondent’s alternative position adjusts the on-going royalties in the amounts of \$415,740,000 and \$569,580,000 for the 2008 and 2009 taxable years, respectively (“Alternative Adjustment Position”).

13. With respect to the Alternative Adjustment Position, respondent alleges the 40% gross valuation misstatement penalty applies. Alternatively, respondent alleges the 20% substantial valuation misstatement penalty, 20% penalty for negligence or disregard of rules or regulations, and 20% substantial understatement of income tax penalty for the Alternative Adjustment Position apply. The amounts of the deficiencies and penalties under the Alternative Adjustment Position will be calculated in a Rule 155 computation, if necessary.

14. The initial determination to assess the penalties raised in the Amendment to Answer was not formally communicated to petitioner until the filing of the Amendment to Answer.

15. After the filing of the Answer in this case on November 30, 2018, attorneys for respondent, Lloyd T. Silberzweig and My V. Vo, made an initial determination to assert the penalties and additions to tax by filing the

Amendment to Answer. In accordance with Code section 6751(b)(1), Messrs. Silberzweig and Vo have obtained written supervisory approval for this initial determination. Specifically, their immediate supervisors, H. Clifton Bonney, Jr. and Shawn L. Barrett, approved this initial determination, in writing, by signing the Amendment to Answer. As such, respondent has complied with Code section 6751(b)'s written-approval requirement.

16. According to Code section 6214(b) the Court has jurisdiction to determine these penalties and additions to tax.

17. Denies generally each and every allegation of the Petition not herein specifically admitted, qualified, or denied.

WHEREFORE, it is prayed:

- (1) That the Court find that respondent did not err as alleged;
- (2) That the relief sought in the Petition be denied;
- (3) That respondent's determinations, as set forth in the Notice, be in all respects approved;
- (4) That the penalties under provisions of Code sections 6662(b)(3) and 6662(e)(1)(B), as modified by Code section 6662(h), for the 2008 taxable year, as set forth herein, be in all respects approved;

(5) That in the alternative, the penalties under the provisions of Code sections: (A) 6662(b)(3) and (e)(1)(B); (B) 6662(b)(1) and (c); or (C) 6662(b)(2) and (d), for the 2008 taxable year, as set forth herein, be in all respects approved as set forth above;

(6) That in the alternative consistent with the Alternative Adjustment Position, the penalties under provisions of Code sections 6662(b)(3) and 6662(e)(1)(B), as modified by Code section 6662(h), for the 2008 and 2009 taxable years, as set forth herein, be in all respects approved; and

(7) That in the alternative consistent with the Alternative Adjustment Position, the penalties under the provisions of Code sections: (A) 6662(b)(3) and (e)(1)(B); (B) 6662(b)(1) and (c); or (C) 6662(b)(2) and (d), for the 2008 and 2009 taxable years, as set forth herein, be in all respects approved as set forth above.

MICHAEL J. DESMOND
Chief Counsel
Internal Revenue Service

Date: 05/04/2020

By:

**Lloyd T.
Silberzweig**

Digitally signed by Lloyd T. Silberzweig
DN: c=US, o=U.S. Government,
ou=Department of the Treasury, ou=Internal
Revenue Service, ou=People,
serialNumber=408792, cn=Lloyd T. Silberzweig
Date: 2020.05.04 13:43:26 -0700'

LLOYD T. SILBERZWEIG
Special Trial Attorney
(Large Business & International)
Tax Court Bar No. SL0630
100 First Street, Suite 1800
San Francisco, CA 94105
Telephone: (415) 547-3806
Lloyd.T.Silberzweig@irscounsel.treas.gov

Date: 05/04/2020

By:

My V. Vo

Digitally signed by
My V. Vo
Date: 2020.05.04
12:44:26 -07'00'

MY V. VO
Attorney
(Large Business & International)
Tax Court Bar No. VM0121
915 2nd Avenue, Room 2704
Seattle, WA 98174
Telephone: (206) 946-3623
My.V.Vo@irscounsel.treas.gov

Supervisors:

Date: 05/04/2020

By:

**Henry C.
Bonney Jr.**

Digitally signed by Henry C. Bonney Jr.
DN: c=US, o=U.S. Government,
ou=Department of the Treasury,
ou=Internal Revenue Service,
ou=People, serialNumber=407004,
cn=Henry C. Bonney Jr.,
Date: 2020.05.04 14:59:00 -0700

H. CLIFTON BONNEY JR.
Deputy Area Counsel (SL)
(Large Business & International)
Tax Court Bar No. BH0592
100 First Street, Suite 1800
San Francisco, CA 94105
Telephone: (415) 547-3707
Henry.C.Bonney@irsounsel.treas.gov

Date: 05/04/2020

By:

**Shawn L.
Barrett**

Digitally signed by Shawn L. Barrett
DN: c=US, o=U.S. Government,
ou=Department of the Treasury,
ou=Internal Revenue Service, ou=People,
serialNumber=490662, cn=Shawn L. Barrett,
Date: 2020.05.04 14:22:13 -0700

SHAWN L. BARRETT
Associate Area Counsel
(Large Business & International)
Tax Court Bar No. BS0640
915 2nd Avenue, Room 2704
Seattle, WA 98174
Telephone: (206) 946-3620
Shawn.L.Barrett@irsounsel.treas.gov

OF COUNSEL:

ROBIN L. GREENHOUSE
Division Counsel (CC:LB)
EWAND. PURKISS
Area Counsel (CC:LB:5)

Morgan Lewis

Sanford W. Stark

Partner
+1.202.373.6678
sanford.stark@morganlewis.com

May 4, 2020

VIA ELECTRONIC MAIL

Lloyd T. Silberzweig
Special Trial Attorney (Large Business & International)
Internal Revenue Service
100 First Street, Suite 1800
San Francisco, CA 94105

Re: Western Digital Corporation and Subsidiaries v. Commissioner
Tax Court Docket Nos. 18984-18 and 4818-19
Written Consent to Amend Answers

Dear Mr. Silberzweig:

This letter is to notify you that petitioner consents to respondent's amending his Answers under Rule 41(a) of the Tax Court Rules of Practice and Procedure. Petitioner disagrees with respondent's assertion of penalties and will address this issue in petitioner's Replies.

Sincerely,

E-SIGNED by Sanford Stark

Sanford W. Stark

Morgan, Lewis & Bockius LLP

1111 Pennsylvania Avenue, NW
Washington, DC 20004
United States

+1.202.739.3000
+1.202.739.3001

Exhibit A
Docket No. 18984-18