



Update on *Xilinx* and Cost Sharing

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Xilinx – Key Facts

- Xilinx entered into a Technology Cost and Risk Sharing Agreement (“CSA”) with Xilinx Ireland (“XI”), a second-tier wholly-owned foreign subsidiary of Xilinx.
- Under the CSA, Xilinx and XI were required to share direct costs, indirect costs, and costs of acquired intellectual property rights.
- The CSA did not specifically address whether employee stock options were costs includible in the cost share pool.

Xilinx – Key Facts

- Xilinx and XI also had a separate agreement, pursuant to which XI paid Xilinx an amount equal to the market price of Xilinx stock on the exercise date minus the exercise price (the “spread”) each time that an XI employee exercised a Xilinx stock option.
- In determining the allocation of costs pursuant to the CSA for tax years 1997, 1998, and 1999, Xilinx did not include any amount related to the employee stock options.

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Xilinx – Timeline

- August 30, 2005: Tax Court Decision (“Xilinx I”)
- May 27, 2009: Original Ninth Circuit Panel Opinion (“Xilinx II”)
- January 13, 2010: Ninth Circuit Panel withdrew its original opinion.
- March 22, 2010: Ninth Circuit Panel issued second opinion (“Xilinx III”)

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Positions of the Parties - Taxpayer

- The inclusion of stock-based compensation in cost-sharing arrangements is contrary to the arm's length standard because unrelated parties would not share such costs.
- The taxpayer introduced evidence regarding cost sharing arrangements between uncontrolled persons, none of which included stock-based compensation in their cost sharing pools.

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Positions of the Parties - IRS

- At trial and on appeal, the IRS argued that the "all costs requirement" under Treas. Reg. § 1.482-7(d)(1)(1995) was consistent with the arm's length standard as modified by the commensurate-with-income language added to section 482 in 1986.
 - The IRS specifically argued that the 1986 amendment was intended "to supplant the use of comparable transactions with internal measures of cost and profit."
 - In essence, the IRS maintained that its method met with the arm's length standard, as defined by the IRS.

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Tax Court Decision (“Xilinx I”)

- Held: the inclusion of stock-based compensation was contrary to the arm’s length standard because unrelated parties would not share such costs in cost-sharing arrangements.
- Reasoning:
 - Commensurate-with-income standard was “intended to supplement and support, not supplant” the arm’s length standard.
 - “The express language in section 1.482-1(a)(1) . . . establishes that the arm’s-length standard applies to section 1.482-7 . . . for purposes of determining appropriate cost allocations.”
 - Factual finding that unrelated parties do not share the spread or the grant date value of stock options.

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Original Ninth Circuit Opinion (“Xilinx II”)

- Ninth Circuit reversed Tax Court in a 2:1 panel opinion.
- Held: Treas. Reg. § 1.482-7(d)(1), the more specific regulation, controlled, and the “all costs requirement” included stock options.
- Reasoning:
 - The majority concluded that the arm’s length standard in the regulations under Treas. Reg. §§ 1.482-1(a)(1) and (b)(1) and the “all costs requirement” under Treas. Reg. § 1.482-7(d)(1) could not be reconciled.
 - Decision relied on the canon of statutory construction that a more specific regulation must be respected when it is contradicted by a more general statute.

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Petition for Rehearing - Xilinx Position

- Xilinx observed that the Ninth Circuit panel's majority opinion accepted the Tax Court's finding that unrelated parties would not share stock option costs, and had rejected the IRS' reallocation of stock option deductions because it was inconsistent with the arm's length standard, but nonetheless sustained the reallocation under section 482.
- Xilinx argued that the majority's opinion was an "unprecedented departure from the arm's length standard" that warranted further review.

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Petition for Rehearing - Xilinx Position

- Xilinx stressed that Treasury has never varied from the position that the arm's length standard applies to all transfer pricing issues, including cost sharing, that Treasury has always correctly understood that section 482 required use of the arm's length standard, and that the regulations required arm's length results.
- Numerous businesses, business groups, and former government officials filed *amicus curiae* briefs in support of the Xilinx petition for reconsideration of the original Ninth Circuit opinion.

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Petition for Rehearing – IRS Position

- Commissioner reiterated the view that the two regulations could be reconciled, but also suggested that the majority had followed the Commissioner's "fall-back" position that the specific regulation controls the general regulation.
- The Commissioner maintained that the majority reached the right result, and due to the 2003 revision of the regulations at issue, "the majority's reasoning has no continuing significance in terms of U.S. transfer pricing law."
- Finally, the Commissioner argued that the U.S.-Ireland Treaty has no direct application to the Xilinx dispute, which was a dispute between the U.S. and a U.S. corporation.

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Second Ninth Circuit Opinion ("Xilinx III")

- Held: stock option expenses need not be included in the pool of costs to be shared in a cost sharing agreement because unrelated parties operating at arm's length would not share such costs.
- Reasoning:
 - Factual finding that unrelated parties at arm's length would not share these amounts.
 - Recognized inherent conflict between language of Treas. Reg. §1.482-1(b)(1) and that of Treas. Reg. § 1.482-7(a)(2).
 - In choosing between specific governing general vs. overriding purpose the court held that "purpose is paramount"
 - Regulation cannot be construed to "stultify" the purpose of the statute
 - Purpose of regulation is to achieve parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions

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Second Ninth Circuit Opinion (“Xilinx III”)

- The majority also observed that the U.S.-Ireland Treaty contained the arm’s length standard.
 - While declining to decide whether treaty obligations constitute binding federal law in U.S. courts, the majority opined that it was “enough that our foreign treaty partners and responsible negotiators in the Treasury thought that arm’s length should function as the readily understandable measure.”

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Looking Ahead

- The IRS generally has 45 days to file a Ninth Circuit motion and 90 days to file a U.S. Supreme Court petition.
- Other controversies regarding the treatment of stock option expenses under U.S. cost sharing regulations are pending.

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