

Xilinx: The Saga Continues

The IRS appealed the decision in the Xilinx case to the Court of Appeals for the Ninth Circuit, which initially held in favour of the IRS. However, a subsequent reissuance of the decision resulted in a decision in favour of the taxpayer. This article considers the latest developments in this long-running dispute.

1. Background

Xilinx Inc (Xilinx) established a cost sharing arrangement with Xilinx Ireland (XI), its Irish subsidiary, in 1995. The IRS audited the 1997-1999 tax years and concluded that stock option expenses relating to Xilinx's R&D employees should have been included in the costs to be shared under that arrangement. Xilinx disagreed with the assessment and the case was heard by the US Tax Court.

In the Tax Court, Xilinx argued that unrelated third parties do not share employee stock option expenses; therefore, to require that these costs be shared violates the arm's length standard. The IRS argued that the commensurate-with-income standard required that "all" costs be shared, even if that required related parties to share costs that unrelated parties would not share.

The Tax Court held, in its August 2005 decision, that the commensurate-with-income standard does not replace the arm's length standard, but merely supplements and supports it. Further, the Tax Court concluded that the arm's length standard applies to all intercompany transactions, including cost sharing arrangements. Because unrelated parties do not share employee stock option expenses, the IRS' attempt to require sharing of such costs is inconsistent with the arm's length standard, and the transfer pricing regulations in effect during the years at issue did not require sharing of such expenses.

The IRS appealed the Tax Court decision to the United States Court of Appeals for the Ninth Circuit. On 27 May 2009, a three-judge panel determined that the Tax Court decision should be overturned. As has been widely discussed, the two judges representing the majority determined that employee stock options are to be included in costs to be shared under cost sharing arrangements. The decision was based on a legal canon that requires the specific to prevail over the general, i.e. the specific requirement in the cost sharing regulations that "all" costs be shared trumps the general arm's length requirement in the US Sec. 482 regulations.

Xilinx petitioned for a rehearing, and on 13 January 2010, the Ninth Circuit withdrew its opinion. On 22 March 2010 the original three-judge panel reissued its decision, this time affirming the Tax Court decision by a 2-1 majority.

2. New Ninth Circuit Decision

Judge Noonan, writing for the majority, recognizes the ambiguity in the Sec. 482 regulations. On the one hand, those regulations state that US transfer pricing law requires application of the arm's length standard "in every case". This means that costs that unrelated parties would not share should not be shared in intercompany arrangements. On the other hand, the Sec. 482 regulations that deal specifically with cost sharing require sharing of "all" costs, which the IRS argued at trial includes stock option expenses. Judge Noonan states that this ambiguous standard can be decided in either of two ways. First, one could apply "a rule of thumb", which is what the majority did in the first Appeals Court decision. Judge Noonan rejects this approach as "wrong".

Second, Judge Noonan states that the ambiguity can be resolved based on the dominant purpose of the regulations, i.e. the arm's length standard. Judge Noonan states that the purpose of the regulations is paramount. The purpose of Sec. 482 is parity between taxpayers in uncontrolled and controlled transactions. If this is trumped by the "all" costs requirement in the cost sharing regulations, then the purpose of the statute is frustrated in Judge Noonan's opinion.

Judge Fisher, who decided with the majority in the prior Appeals Court decision, concurred with Judge Noonan in the most recent decision. In the latest decision, he states that the regulations are contradictory in that the more general requirement contained in Reg. Sec. 1.482-1 states that all intercompany transactions must be priced at arm's length, while the specific rules applying to cost sharing, and contained in Reg. Sec. 1.482-7 require the sharing of all costs. Interestingly, Judge Fisher concludes that "it is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case".¹ He states further that the Sec. 482 regulations "are hopelessly ambiguous and the ambiguity should be resolved in favour of what appears to have been the commonly held understanding of the meaning and purpose of the arm's length standard prior to this litigation".

Judge Reinhardt, in his dissenting opinion, continues to believe that the specific should trump the general, and he does not believe that the Tax Court decision favouring Xilinx should have been affirmed.

* Wright Economics, Golden, Colorado.

1. United States Court of Appeals for the Ninth Circuit; *Xilinx Inc. v. Commissioner* (22 March 2010), footnote 4.

3. What Is Next?

At this point, the IRS may ask for an *en banc* hearing before the entire Ninth Circuit, it may appeal to the Supreme Court, it may ask Congress to change the law, or

it may do nothing and wait for another cost sharing case, presumably under the new regulations, and litigate anew. The only thing one can be certain of is that this issue is likely to be around for many years to come.

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