

R&D Cost Sharing: The *Xilinx* Appeal

The United States Court of Appeals for the Ninth Circuit recently issued its decision regarding the appeal by the IRS in the *Xilinx* case. This article considers the case history, including the ruling of the Court of Appeals in favour of the IRS. The authors also address the impact of this case on tax litigation related to cost sharing arrangements, as well as future prospects.

1. Introduction

Xilinx Inc (Xilinx), a US company, manufactures and sells programmable logic devices, integrated circuit devices and other development software systems. In April 1995, it established a manufacturing subsidiary, Xilinx Ireland (XI), to manufacture products and to increase its market share in European markets.

To assist XI in achieving its business purpose, Xilinx and XI entered into a cost sharing agreement (the Agreement) on 2 April 1995 to jointly develop new technology in the integrated circuit devices industry. In accordance with the Sec. 1.482-7 regulations, the Agreement specified that the research and development (R&D) costs would be shared based on anticipated benefits from the new technology, which would be jointly owned by the participants. Each year the anticipated benefits were to be reviewed and the percentage of costs contributed or paid by each party were to be adjusted if needed to ensure that costs were commensurate with expected benefits.

The Agreement specified that the costs to be shared included direct R&D costs (such as salaries, bonuses and other payroll costs and benefits), indirect costs (administrative, legal and accounting department costs, and insurance costs) and acquired intellectual property rights costs (costs incurred due to the acquisition of products or intellectual property rights). However, costs from employee stock options issued to employees engaged in R&D were not included.

The Internal Revenue Service (IRS) audited Xilinx's 1995-1999 income tax returns and assessed additional tax associated with the R&D cost sharing arrangement. The IRS' argument was that Xilinx should have shared employee stock option expenses in addition to the costs that were shared. Xilinx disagreed with the assessment and the case was heard by the US Tax Court.

2. Tax Court

At trial, Xilinx presented testimony that unrelated third parties do not share employee stock option expenses when they enter into cost sharing arrangements.¹ This fact was not disputed by the IRS. Instead, the IRS argued that the commensurate-with-income standard requires

that "all" costs be shared, even if that requires related parties to share costs that unrelated parties would not share. A corollary to this argument is the IRS' contention that the commensurate-with-income standard replaced the arm's length standard for US transfer pricing purposes. The IRS' argument, at its heart, was that employee stock options are payment for services rendered, i.e. employee compensation, and as a result, these costs must be shared to have a valid cost sharing arrangement.

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 United States is on an arm's length standard that 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. Xilinx's position was validated.

3. Court of Appeals

The IRS appealed the Tax Court decision to the United States Court of Appeals for the Ninth Circuit. The appeal was heard by a three-judge panel that rendered a split decision on 27 May 2009. In a curious argument, the two judges representing the majority determined that employee stock options were required to be included in cost sharing arrangements. The dissenting judge wrote a scathing rebuttal to the opinion rendered by the majority.

The majority's decision, in essence, is that "related companies in a cost sharing agreement to develop intangibles must share *all* costs related to the joint venture, even if unrelated companies would not do so".² The majority decision is based on their conclusion that the Sec. 482 regulations are internally inconsistent and contradictory. It is interesting to note that the law (Sec. 482 of the Internal Revenue Code) does not mention the arm's length standard. It merely states that the IRS Commissioner may:

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1. Xilinx also argued that there was no outlay of cost upon issuance of employee stock options, which means that no cost was incurred. Instead, Xilinx argued that the cost associated with employee stock options was borne by shareholders, and finally, they argued that the costs are not related to "intangible development". These positions were not accepted by the Tax Court.

2. United States Court of Appeals for the Ninth Circuit, *Xilinx Inc. v. Commissioner* (27 May 2009).

...distribute, apportion, or allocate gross income, deductions, credits, or allowances ... if he determines that such ... is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property ... the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The arm's length standard is not included in the law. Rather, it is introduced only in the regulations that interpret the law. In this regard, Sec. 1.482-1(b), states:

(b) *Arm's Length Standard.* – (1) *In general.* In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.

The Sec. 1.482-1 regulations are general requirements applying to all intercompany transactions. Following that section are sections dealing specifically with various types of intercompany transactions, e.g. sales of tangible property, licences of intangible property, provision of services, and R&D cost sharing arrangements. The problem that the Court of Appeals addressed is an apparent inconsistency between Sec. 1.482-1 of the regulations and the section that deals with cost sharing arrangements (Sec. 1.482-7). Specifically, Sec. 1.482-7 requires that “all” R&D costs be shared by participants to a cost sharing arrangement.

The Tax Court dealt with this apparent inconsistency by stating that the United States is on the arm's length standard. Because the Tax Court concluded that unrelated parties do not share employee stock option costs, the Court held that Xilinx should not be required to share such expenses when dealing with XI. The majority of the Court of Appeals reached the opposite conclusion. To reach that conclusion, the majority used a general rule that “the specific trumps the general”. In short, the Court of Appeals concluded that the (specific) “all costs” provision of the cost-sharing regulations trumps the (general) arm's length standard language contained in Sec. 1.482-1. The Court of Appeals stated, “The two provisions establish distinct and irreconcilable standards for determining which costs must be shared between controlled parties in cost sharing agreements.”³

As stated above, the Court of Appeals decision was not unanimous. In the dissenting opinion, Judge John T. Noonan, Jr. agreed that the two standards were irreconcilable, but disagreed with the decision of the majority to resolve the conflict using a “rule of thumb”. Instead, he stated that the decision should be based on the purpose of the regulations, the way they have been interpreted in treaties and the notion that an ambiguous document must be held against the drafter.

In his dissent, Judge Noonan argued that the intent of regulations was to treat controlled taxpayers the same way that uncontrolled taxpayers are treated, such that no tax advantage or disadvantage results from related-party transactions. This is achieved through the arm's length

standard. The majority decision to ignore what unrelated parties would do in arm's length cost sharing agreements was tantamount to interpreting the law “contrary to the intent of its maker”. Judge Noonan stated further that the IRS (US Treasury) undercut its *Xilinx* litigating position when it based its treaty with Ireland on the arm's length standard. Because the Commissioner must respect the provisions of that treaty, Judge Noonan argued that the arm's length standard should have been used to decide the *Xilinx* appeal. Finally, the dissent cited previous court decisions that held that inconsistencies in the regulations “must be construed against the drafter”. In short, he found that the Tax Court had correctly applied the law.

4. Where Do We Go from Here?

The cost-sharing regulations have been amended twice since the 1995-1999 tax years that were the subject of the Court of Appeals decision. In particular, proposed Sec. 1.482-7 regulations were issued in 2005, and temporary Sec. 1.482-7T regulations were issued in 2008, both of which amend the regulations that were examined in the *Xilinx* case. While all three versions of the regulations contain similar language as it applies to the issue in *Xilinx*, the regulations have been changing, and this may raise questions as to the precedential value of the *Xilinx* decision.

Having said that, it is clear that several of the world's tax authorities, including the IRS, have been steadily moving away from the arm's length standard, particularly as it applies to transfers of intangibles. For example, many governments, including the US government, have been “identifying” intangibles that would not exist in arm's length relationships, e.g. goodwill, workforce in place and “marketing intangibles” that are separate from a trademark. The Tax Court may have been signalling its intention to decide cases based on the arm's length standard. The Court of Appeals decision does not seem to add clarity to that debate.

Xilinx has not yet announced whether it will appeal the latest decision. Its options include requesting a rehearing, appealing to the entire Ninth Circuit of the Court of Appeals, or appealing to the US Supreme Court. The Supreme Court famously dislikes tax cases, which suggests that an appeal to the Ninth Circuit is the more likely route.

In the next audit cycle, the IRS has reassessed Xilinx on the basis of faults that it believes continue to exist in Xilinx's cost sharing agreement. That case has now been docketed in the Tax Court. It will be interesting to watch the *Xilinx* cases unfold. We have not heard the last of this debate!

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3. Id, Sec. III.A.