

TAX MANAGEMENT

MEMORANDUM

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Reconciling the “Irreconcilable” -1(b)(1)/ -7(d)(1) Conflict; Understanding the “All Costs” Requirement to Mean “All Costs Shared by Arm’s-Length Parties”: *Xilinx v. Comr.* Revisited

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On May 27, 2009, after reviewing the structure and the regulatory history of the Code §482 regulations,¹ and finding the “arm’s-length standard” of Regs. §1.482-1(b)(1) and the “all costs requirement” of Regs. §1.482-

¹ Unless otherwise provided, all statutory references are to the Internal Revenue Code of 1986, as amended, and all regulatory references are to the regulations issued by the Treasury Department thereunder.

7(d)(1) “irreconcilable,” the majority of the panel for the Ninth Circuit reversed the Tax Court’s decision in *Xilinx v. Comr.*² On appeal, Xilinx pointed out that this “irreconcilable” conflict could be reconciled by understanding the all costs requirement of Regs. §1.482-7(d)(1) to mean “all costs that would be shared by arm’s-length parties.”³ This view, that the all costs requirement is subject to the arm’s-length standard, is supported by the predecessor cost sharing regulations (dating back to 1968), which authorized the Commissioner to make allocations in a bona fide cost sharing arrangement only “to reflect each participant’s arm’s length share of costs and risks.”⁴

After reviewing the Ninth Circuit’s decision, this article reviews the regulatory history of cost sharing regulations, and concludes that the majority for the Ninth Circuit simply got it wrong — as Xilinx suggested, the all costs requirement of Regs. §1.482-7(d)(1) should be read to mean “all costs that would be shared by arm’s-length parties.”

² 567 F.3d 482 (9th Cir. 2009), *rev’g* 125 T.C. 37 (2005).

³ Xilinx has reiterated this solution in its petition for rehearing or rehearing *en banc Xilinx, Inc. v. Comr.*, Petition for Rehearing or Rehearing *en banc* of Appellee Xilinx, Inc., Nos. 06-74246 and 06-74269, at p. 12 n. 8 (9th Cir. 2009).

⁴ Former Regs. §1.482-2(d)(4) (Emphasis added).

BACKGROUND

The Cost Sharing Arrangement; ESOs; Notices of Deficiency

Xilinx sells integrated circuits and related software; its subsidiary, Xilinx Ireland (XI), conducts a similar business in Europe. In 1995, Xilinx and XI entered into a cost sharing arrangement (when referring to arrangements between commonly controlled parties that satisfy the various criteria for special treatment under the §482 regulations, “CSA”) to share the costs and benefits of developing new technology. Under the CSA, each party was required to pay a percentage of the total R&D costs in proportion to its reasonably anticipated benefits (the “RAB share”) with respect to such new technology. The CSA further provided that each year the parties would review and, when appropriate, adjust the cost sharing percentages to ensure that costs continued to be based on the RAB share of each party.

In 1996, Xilinx and XI entered into two intercompany agreements. The first intercompany agreement provided that the costs incurred by Xilinx for the grant or exercise of employee stock options (ESOs) by XI employees would be borne by XI. The other intercompany agreement allowed XI employees to purchase Xilinx stock through payroll deductions.

During the taxable years in question, Xilinx did not include the cost of ESOs in the CSA cost pool.

On December 28, 2000, and October 17, 2002, the IRS issued notices of deficiency to Xilinx relating to the 1996 through 1999 taxable years. In its notices of deficiency, the IRS determined that Xilinx was required, pursuant to the CSA, to share the costs of certain ESOs with XI. The IRS determined that the costs required to be taken into account equaled the spread (i.e., the stock’s market price on the exercise date over the exercise price) relating to the ESOs exercised by Xilinx’s employees.

On March 26, 2001, and January 14, 2003, Xilinx timely filed its petitions with the Tax Court seeking a redetermination of the deficiencies set forth in the December 28, 2000, and October 17, 2002 notices. On April 4, 2002, the parties stipulated that no amount of expense relating to ESOs would be included in Xilinx’s 1996 CSA cost pool.

In response to joint motions for summary judgment, the court addressed the significance of the government’s inability to find actual uncontrolled cost sharing arrangements in which ESO costs were shared. The court concluded that, although the government did not have to present such arrangements in order to prevail, in the absence of such comparable uncontrolled arrangements the taxpayer would prevail

if it could show that uncontrolled parties “would not share” such costs.⁵

The Tax Court Decision

Following a trial on the merits, the Tax Court found that the express language in Regs. §1.482-1(a)(1) establishes that the arm’s-length standard applies to the CSA provisions of Regs. §1.482-7 for purposes of determining the appropriate cost allocations. During the trial, the IRS conceded that it could not find any comparable uncontrolled intangible development arrangements in which the parties explicitly included ESO costs in the base of costs to share.⁶ Instead, it argued that uncontrolled parties implicitly share ESO costs by adjusting the other financial aspects of their arrangements to take into account those costs. Based on the testimony of the taxpayer’s experts, the court concluded that unrelated parties would not share ESO costs even implicitly “because [such costs are] difficult to estimate, unpredictable, and potentially large in amount.”⁷ As such, the IRS’s requirement to share such was inconsistent with the arm’s-length standard of Regs. §1.482-1. Accordingly, the Tax Court held that:

- The IRS’s allocations were arbitrary and capricious;
- Xilinx’s cost allocations met the arm’s-length standard mandated by Regs. §1.482-1; and
- Xilinx was not liable for §6662(a) penalties.⁸

The IRS timely appealed the decision of the Tax Court.

THE NINTH CIRCUIT’S DECISION

On appeal, the IRS did not dispute the Tax Court’s factual finding that unrelated parties would not share ESO costs. Instead, the IRS maintained that ESOs are a cost that must be shared under Regs. §1.482-7(d)(1), even if unrelated parties would not share them.

The “Irreconcilable” Difference: -1(b)(1) v. -7(d)(1)

The Ninth Circuit began its review by comparing the requirements of Regs. §1.482-1(b)(1) and Regs. §1.482-7(d)(1). It noted that Regs. §1.482-1(b)(1) states that the standard to be employed “in every

⁵ *Xilinx, Inc. v. Comr.*, 125 T.C. 37, 48 (2005).

⁶ *See id.* at 54.

⁷ *Id.* at 59.

⁸ *Id.* at 62-63.

case” (to ensure taxpayers accurately reflect income from controlled transactions and do not avoid taxes through such transactions) is the arm’s-length standard:

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. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results what would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result). However, because identical transactions can rarely be located, whether a transaction produces an arm’s length result generally will be determined by reference to comparable transactions under comparable circumstances.⁹

The court then noted, however, that Regs. §1.482-7(d)(1) requires that controlled parties to a CSA must include “all” costs in the CSA cost pool (the “*all costs requirement*”):

For purposes of this section, a controlled participant’s costs of developing intangibles for a taxable year mean[s] all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in [Regs. §] 1.482-4(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses (as defined in [Regs. §] 1.482-5(d)(3)) the charge for the use of any tangible property made available to the cost sharing arrangement.¹⁰

The court concluded that the two provisions establish “distinct and irreconcilable standards” for determining which costs must be shared by controlled parties to a CSA:

⁹ *Xilinx, Inc. v. Comr.*, 567 F.3d 482, 487 (9th Cir. 2009) *citing*, Regs. §1.482-1(b)(1).

¹⁰ *Id.*, *citing*, Regs. §1.482-7(d)(1). For purposes of this regulatory provision, “operating expenses” are defined as including all expenses not included in cost of goods sold except for interest expense, foreign income taxes [and] domestic income taxes, and any other expenses not related to the operation of the relevant business activity. *See* Regs. §1.482-5(d)(3).

[Regs. §] 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based how parties operating at arm’s length would behave. The language is unequivocal: this arm’s length standard is to be applied “in every case.” In the context of cost sharing agreements, this would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, [Regs. §] 1.482-7(d)(1) specifies that controlled parties in a cost sharing agreement must share *all* “costs . . . related to the intangible development area,” and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision’s plain language mandates a different result. Accordingly, we conclude the two provisions establish distinct and irreconcilable standards for determining which costs must be shared between controlled parties in cost sharing agreements specifically related to intangible product development.¹¹

The court then went on to observe that the structure of the §482 regulations confirms the irreconcilability of the arm’s-length standard of Regs. §1.482-1(b)(1) and the all costs requirement of Regs. §1.482-7(d)(1). It noted that Regs. §1.482-1(b)(2), which identifies the various arm’s-length pricing methods, references only Regs. §§1.482-2–1.482-6. The Ninth Circuit also noted that the “best method rule” of Regs. §1.482-1(c) identifies “comparability” and the “quality of the data and assumptions” as the two primary factors to be taken into account in a best-method analysis. These observations led the court to conclude that Regs. §1.482-7 is a “self-contained provision” that is an exception to the methodology established by Regs. §1.482-1 through Regs. §1.482-6:

Notably, [Regs. §] 1.482-7 is not included among the methods specified in [Regs. §] 1.482-1(b)(2) for determining the arm’s length result, and the comprehensive definition of ‘costs . . . related to the intangible development area’ does not implicate the factors identified in [Regs. §] 1.482-1(c)(1). Thus, [Regs. §§] 1.482-1 through 1.482-6 establish a sophisticated methodology for comparing controlled transactions to uncontrolled trans-

¹¹ *Id.* at 488.

actions that is generally applicable when determining what items must be allocated among related parties. The regulatory regime then addresses a particular type of controlled transaction — cost sharing agreements related to intangible product development — and establishes a comprehensive definition of what costs must be shared that does not turn on similar uncontrolled transactions. [Regs. §] 1.482-7 thus appears to be a self-contained provision creating an exception to the general methodology established by the earlier provisions.¹² [Emphasis added.]

Then, seemingly without the benefit of reading the predecessor cost sharing regulations, the court pointed out that the “separateness” of Regs. §1.482-7 is supported by the regulatory history of the §482 regulations because the proposed and final cost sharing regulations were issued separate and apart from the other §482 regulations:

The Secretary’s separate regulatory action addressing cost sharing agreements related to intangible product development lends further support to our conclusion that the all costs requirement is different from the arm’s length standard generally applicable to other controlled transactions.¹³

Finally, in light of the “irreconcilable” difference between the all costs requirement of Regs. §1.482-7(d)(1) and the arm’s-length standard of Regs. §1.482-1(b)(1), the court invoked the rule of statutory construction that, absent a “clear indication otherwise,” a specific statute is not controlled by the general statute.¹⁴ Under this rule of statutory construction, the majority found that the general rule Regs. §1.482-1(b)(1) does not “override” the specific provision of Regs. §1.482-7(d)(1).

Further, the majority was not persuaded by either party’s attempt to harmonize the two provisions. As noted above, Xilinx argued that Regs. §1.482-1(b)(1)’s “in every case” language required the court to construe Regs. §1.482-7(d)(1)’s all costs requirement to mean that parties must share only those costs that parties operating at arm’s length would share — suggesting that Regs. §1.482-7(d)(1) did not explicitly incorporate an arm’s-length standard because that requirement is implicit, and controlling, in light of

Regs. §1.482-1(b)(1). Although the Ninth Circuit majority noted that such an explanation might sound plausible at first blush, the court ultimately was not persuaded:

To read such a qualification into the precise and comprehensive language of [Regs. §§] 1.482-5(d)(3) and 1.482-7(d)(1) would ignore the plain meaning and context of the cost sharing provisions, specifically “all” costs “related to” intangible development. “All” means “the entire number, amount or quantity” or “every,” and “related” means “[b]eing connected [or] associated.” These terms, taken together with the regulation’s sub-definitions, describe a fixed set of costs that must be shared in their totality and that will not vary based on the type of intangible property being developed. Transporting an arm’s length standard into [Regs. §] 1.482-7(d)(1) would transform this apparently all encompassing self-contained *description* of the costs to be shared into a *methodology* under which the costs to be shared would not be fixed by these defined terms but would rather ultimately be defined by the conduct of unrelated parties. Significantly, achieving an arm’s length result is not itself the regulatory regime’s goal; rather, its purpose is to prevent tax evasion by ensuring taxpayers accurately reflect taxable attributable to controlled transactions.¹⁵ [Emphasis in the original.]

Regs. §1.482-7(d)(1) v. The United States-Ireland Tax Treaty

Having found that Regs. §1.482-7(d)(1) trumps Regs. §1.482-1(b)(1), the court then considered whether the all costs requirement of Regs. §1.482-7(d)(1) is at odds with the United States-Ireland Tax Treaty as in effect during the taxable years in question (the “Treaty”). Ultimately, the court found that Regs. §1.482-7(d)(1) does not conflict with the Treaty, because the Treaty expressly allows (under its “saving” clause), a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty.¹⁶ Because Xilinx is not a foreign entity, applying Regs. §1.482-7(d)(1) to it does not violate the Treaty even if the regulation’s all costs requirement is at odds with the Treaty’s arm’s-length standard.

¹² *Id.*

¹³ *Id.* at 489.

¹⁴ *Id.*, citing *Santiago Salgado v. Garcia*, 384 F.3d 769 (9th Cir. 2004), and *Long Island Care at Home, Ltd. v. Coke*, 127 S. Ct. 2339 (2007) (applying this canon of construction to regulations).

¹⁵ *Xilinx, Inc. v. Comr.*, 567 F.3d at 490, citing *American Heritage College Dictionary* 35, 1152 (3d ed. 2000).

¹⁶ See 1997 United States-Ireland Tax Treaty, Art. 1(4) (“Notwithstanding any provision of [this treaty], a Contracting State may tax its residents . . . and its citizens, as if the [treaty] had not come into effect.”).

ESO Costs as Costs Related to the R&D Activity

The Ninth Circuit then turned its attention to whether ESO costs were costs that related to Xilinx's R&D activity. The court first found that the cost of the ESOs was a "cost" for the purposes of Regs. §1.482-7(d)(1). Having determined that Xilinx's ESO costs constitute a "cost" for purposes Regs. §1.482-7(d)(1), the court noted that ESOs are as "related to" an employee's work as any other employment benefits or compensation (e.g., healthcare benefits, retirement contributions). The majority also noted that that Xilinx had claimed the ESOs as part of its R&D credit under §41. As such, the court held the Xilinx's ESOs were related to the work performed by the employees that received them and, therefore, must be shared by parties to a cost sharing arrangement.

The Majority's Conclusion

In light of these findings, the majority of the panel for the Ninth Circuit reversed the Tax Court's decision and remanded it on the narrow issue of whether the IRS's allocation accurately reflected ESO costs for employees specifically involved in tasks relating to the cost sharing arrangement.

The Dissent

Judge Noonan dissented from the majority. He began his critique of the majority opinion by noting that when the IRS issues regulations that are irreconcilable (as here), a court has three choices. It can:

- Hold that when the Commissioner of Internal Revenue "talks out of both sides of his mouth, his speech is unintelligible and his regulations are unenforceable";
- Apply a rule of thumb: the specific controls the general; or
- Resolve the conflict based on the dominant purpose of the regulations, aided by the basic rule that ambiguous documents are to be interpreted against the drafter and further enlightened by the way the Treasury has proceeded in drafting tax treaties relevant to American parents and their foreign subsidiaries.¹⁷

Noting that the majority had chosen the second alternative,¹⁸ Judge Noonan then addressed why he would choose the third alternative.

First, he asserted that the purpose of the relevant regulatory scheme should be the paramount consider-

ation in attempting to reconcile seemingly inconsistent regulatory provisions. Judge Noonan identified the purpose of the regulations under §482 as the enforcement of parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. As such, the regulations should not to be construed to stultify that purpose. Under the majority's holding, Judge Noonan asserted that the law was interpreted contrary to the intent of its maker.

Second, Judge Noonan stated that the case was one where "the complex statutory and regulatory scheme leads itself to any number of interpretations." In such a situation, he said that it was appropriate to resolve any inconsistencies against the government and in favor of the taxpayer.¹⁹

Finally, Judge Noonan found that the Treasury Department, of which the IRS is a part, had taken a contradictory position when negotiating and drafting the tax treaty between the United States and Ireland. He noted that the Treaty:

... adopts as its standard the transactions "that would be made between independent enterprises." That standard is the arm's length standard. No exceptions are provided. Arm's length is the international standard specifically governing Xilinx and XI. A tax treaty is negotiated by the United States with the active participation of the Treasury, The Tre-

It is a simple solution. It is plausible. But it is wrong. It converts a canon of construction into something like a statute. It ignores the international context and the Treasury's own practice.

...

Apply this simple rule here, and [Regs. §] 1.482-7(d)(1) controls. The conflict dissolves. The Commissioner is vindicated.

The simple solution is all too pat. It gives controlling importance to a single canon of construction. But, as every judge knows, the canons of construction are many and their interaction complex. The canons "are not mandatory rules." *Chickasaw Nation v. U.S.*, 534 U.S. 84 (2001). They are guides "designed to help judges determine the Legislature's intent." *Id.* They can be "overcome" by "other circumstances" manifesting that intent. *Id.* The canons are "tools designed to help courts better determine what Congress intended, not to lead courts to interpret the law contrary to the intent." *Schneider v. National Org. of Women, Inc.*, 547 U.S. 9 (2006).

¹⁹ 567 F.3d at 498, citing *United Dominion Industries, Inc. v. U.S.*, 532 U.S. 822 (2001) (Thomas, J., concurring and citing, among other cases, *U.S. v. Merriam*, 263 U.S. 179 (1923) ("If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer"))).

¹⁷ *Xilinx, Inc. v. Comr.*, 567 F.3d at 497.

¹⁸ Judge Noonan wrote:

sury's reading of the treaty is "entitled to great weight."²⁰

Judge Noonan went on to note that the Treasury's technical explanation of the Treaty refers to the arm's-length standard "no fewer than five times," that it makes no specific mention of the all costs requirement, and that the arm's-length standard is in accord with the OECD's Transfer Pricing Guidelines.

Finally, Judge Noonan asserted:

The Commissioner as litigator cannot disavow the position that the Treasury repeatedly took in the Ireland and other tax treaties of which we have judicial notice. In each of them, Article 9 takes transactions between independent companies as the measure. Using the standard of what independent companies would do in their own cost-sharing arrangement, the Treasury could not have meant to conceal from its treaty parties that this standard had an exception when stock options were in question.²¹

Petition for Rehearing

On August 12, 2009, Xilinx filed a petition for rehearing or rehearing *en banc*.²² In its petition, Xilinx made two broad claims regarding the majority's decision:

- It abandons the arm's-length standard as the statutory touchstone for U.S. transfer pricing law; and
- It cannot be reconciled with the arm's-length provisions of U.S. tax treaties.

As noted above, in its petition, Xilinx reiterated that the "irreconcilable" conflict between the arm's-length standard of Regs. §1.482-1(b)(1) can be reconciled with the all costs requirement of Regs. §1.482-7(d)(1) if the all costs requirement is read to mean "all costs that would be shared by arm's-length parties."

THE REGULATORY HISTORY OF THE COST SHARING REGULATIONS

The Ninth Circuit majority's conclusion in *Xilinx* that the allocation of intangible development costs in

²⁰ *Xilinx, Inc. v. Comr.*, 567 F.3d at 499, citing *U.S. v. Stuart*, 457 U.S. 176 (1989), quoting *Sumitomo Shoji America, Inc. v. Aragliano*, 457 U.S. 176 (1982).

²¹ 567 F.3d at 500, citing Article 9 of the United States-France, United States-Germany, and United States-United Kingdom tax treaties.

²² *Xilinx, Inc. v. Comr.*, Petition for Rehearing or Rehearing *en banc* of Appellee Xilinx, Inc., Nos. 06-74246 and 06-74269 (9th Cir. 2009).

a CSA is not subject to the general arm's-length standard of the §482 regulations no doubt strikes most practitioners — and apparently the IRS, which did not advance the position at any time during the litigation — as quite surprising and at least somewhat dubious. Although Judge Noonan's dissent emphasized the overarching significance of the arm's-length standard in transfer pricing, in relying on certain canons of construction and presumptions to criticize the majority's decision, he may have overlooked the more direct link between the arm's-length standard and CSAs that can be found in the regulatory history of the cost sharing regulations.

The 1966 Proposed Cost Sharing Regulations

On August 2, 1966, the IRS and Treasury published proposed regulations with respect to CSAs.²³ The 1966 proposed regulations permitted any affiliate (other than one in the trade or business of producing intangible property) to participate in a CSA, provided the intangible property was intended for use in connection with the active conduct of the affiliate's business. The 1966 proposed regulations specifically authorized CSAs for single projects, but did not disqualify multiple projects or continuing arrangements. The sharing of costs and risks was required to be proportional to the anticipated benefits to be received by each member from the arrangement. Cost sharing was required to be based on sales, profits or other variable criteria.

The 1966 proposed regulations did not explicitly address the "buy-in" question; i.e., the question of how to account for the use of pre-existing intangible property contributed to the development effort by one of the cost sharing participants. Those regulations did, however, require that an arm's-length amount be paid to the affiliate that provides intangibles that substantially contribute to the arrangement. Any required §482 allocation for services provided by other affiliates was also to be included as a cost of the arrangement.

1968 Final Cost Sharing Regulations

On July 25, 1968, the IRS and Treasury published the cost sharing regulations in final form.²⁴ The 1968 final regulations abandoned the requirements of the 1966 proposed regulations in favor of simpler, more general requirements. In relevant part, the 1968 final cost sharing regulations provided:

²³ 31 Fed. Reg. 10394 (1966).

²⁴ T.D. 6964, 33 Fed. Reg. 10569 (7/25/68).

Sharing of costs and risks. — Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate *to reflect each participant's arm's length share of costs and risks* of developing the property . . . In order for an arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their shares of all the costs and risks of development on an arm's length basis. *In order for the sharing of costs and risk to be considered on an arm's length basis*, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement . . .²⁵ [Emphasis added.]

Thus, the 1968 regulations under §482 seemed to apply the arm's-length standard in full to covered CSAs.

The 1992 Proposed Cost Sharing Regulations

On January 30, 1992, the IRS and Treasury issued proposed regulations under §482.²⁶ These proposed regulations introduced the notion that, to be eligible for the prescribed treatment for “qualified cost sharing arrangements” under the §482 regulations, an arrangement would have to involve the sharing of intangible development costs in proportion to the participants' likely shares of the income to be generated from the developed intangibles. The preamble to the 1992 proposed regulations provided in relevant parts:

. . . If the requirements of [Regs. §] 1.482-2(g)(2) and (3) are met (that is, if a qualified cost sharing arrangement exists), the district director may nonetheless make allocations to cost shares, as provided in [Regs. §] 1.482-2(g)(4), *to reflect each participant's arm's length share of costs and risks* of developing intangible property.

. . .

[Regs. §] 1.482-2(g)(4) describes the allocations that may be made by the district director

to reflect each participant's arm's length share of an arrangements costs. [Emphasis added.]

As such, Prop. Regs. §1.482-4(g)(1)(i) provided as follows:

If a member of a group of controlled taxpayers acquires an intangible as an eligible participant in a qualified cost sharing arrangement, the district director may make allocations with respect to that acquisition *to reflect each participant's arm's length share of the costs and risks* of developing the intangible, under the rules of this paragraph (g). If a member of a group of controlled taxpayers acquires an intangible from another member of the group through any means other than as an eligible participant in a qualified cost sharing arrangement, then the district director may make appropriate allocations *to reflect an arm's length consideration* for the intangible under the rules of paragraph (d) of this section. [Emphasis added.]

The 1993 Temporary Regulations and the 1994 Final Regulations

On January 21, 1993, the IRS and Treasury issued temporary regulations under §482. The 1993 temporary regulations left the 1968 cost sharing regulations (and the requirement that costs and risks be shared on an arm's-length basis) intact.

On July 8, 1994, the 1993 temporary regulations were finalized. As was true with respect to the 1993 temporary regulations, the 1994 final regulations left the 1968 cost sharing regulations (and the requirement that costs and risks be shared on an arm's-length basis), intact.

The 1995 Final Cost Sharing Regulations

On December 19, 1995, the 1992 proposed cost sharing regulations were finalized.²⁷ The final 1995 regulations retained the concept introduced in the 1992 proposed regulations that the relevant intangible costs must be shared in proportion to each participant's likely share of income from the developed intangibles. It is the 1995 version of the cost sharing regulations that were at issue in *Xilinx*. As noted above, the 1995 cost sharing regulations provided as follows:

²⁵ Regs. §1.482-2(d)(4) (1968).

²⁶ 57 Fed. Reg. 3571 (1/30/92), as corrected by 57 Fed. Reg. 27716 (6/22/92).

²⁷ T.D. 8632, 60 Fed. Reg. 65553 (12/20/95).

For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of: operating expenses (as defined in [Regs. §] 1.482-5(d)(3)), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses (as defined in [Regs. §] 1.482-5(d)(3)), the charge for the use of any tangible property made available to the cost sharing arrangement.

Inexplicably, the 1995 cost sharing regulations did not include the modifier "arm's length" or "arm's-length share" when describing how to determine or allocate development-related "costs" in a CSA. That said, there is no indication in the preamble that the arm's-length standard had been abandoned with respect to costs shared under a CSA — a change that, if advertent, would have been quite newsworthy. To the contrary, the preamble to the 1995 regulations provides clear and convincing evidence that the arm's-length standard continued to be applicable standard with respect to costs shared under a CSA. When discussing the required charges to be shared, the preamble stated:

[Regs. §] 1.482-7(d) defines intangible development costs as operating expenses other than depreciation and amortization expense, plus an *arm's length charge* for tangible property made available to the cost sharing arrangement. [Emphasis added.]

And again, when discussing Regs. §1.482-7(f), the preamble provided as follows:

[Regs. §] §1.482-7(f) governs cost allocations by the district director in order to make a controlled participant's share of costs equal to its share of reasonably anticipated benefits. Anticipated benefits of uncontrolled participants will be excluded from anticipated benefits in calculating the benefits shares of controlled participants. A share of reasonably anticipated benefits will be determined using the most re-

liable estimate of benefits. *This rule echoes the best method rule for determining the most reliable measure of an arm's length result under [Regs. §] 1.482-1(c).* [Emphasis added.]

CONCLUSION

Starting from the premise that uncontrolled parties at arm's length do not share ESOs in cost sharing arrangements, the Ninth Circuit in *Xilinx* defined its task as coordinating the "all costs" requirement for CSAs contained in Regs. §1.482-7(d)(1) with the general transfer pricing principle in Regs. §1.482-1(b)(1) that §482 mandates that taxpayers allocate income from transactions and arrangements with commonly controlled businesses based on the arm's-length standard by reference to the results of comparable uncontrolled transactions or arrangements. The majority panel somewhat mechanically carried out that task by invoking the canon of construction that a specific regulatory provision takes precedence over a more general regulatory provision. The result is an unsatisfying and, to many transfer pricing practitioners, surprising conclusion that the arm's-length standard does not apply in determining which costs associated with the development of an intangible under a CSA must be shared. The dissent, while taking cognizance of the arm's-length philosophy that has long informed virtually every aspect of transfer pricing, also resorted to some mechanical canons of construction to rebut the majority's opinion.

A close examination of the cost sharing regulations as they have evolved over the last 40-plus years strongly suggests that there has always been an intention to apply the arm's-length standard to CSAs. In fact, the failure of the government to argue, at any level in *Xilinx*, that the arm's-length standard did not apply to CSAs is some evidence of that intention. Although the 1995 cost sharing regulations at issue in *Xilinx* did not literally limit the costs that must be shared in a CSA to those costs that taxpayers take into account in actual uncontrolled cost sharing arrangements, the preamble to those regulations makes clear that the arm's-length principle was intended to apply for that purpose. Given that, and the historic application of the arm's-length standard to cost sharing arrangements going back to 1968, there is a strong basis for concluding that the "all costs" requirement in Regs. §1.482-7(d)(1) should be interpreted to encompass only those development-related costs that uncontrolled parties at arm's length would share.