

***Xilinx*: Time for a Tweak to Treas. Reg. Section 1.482-1(b)(1)?**

by Lewis J. Greenwald

Reprinted from *Tax Notes Int'l*, July 12, 2010, p. 115

FEATURED PERSPECTIVES

Xilinx: Time for a Tweak to Treas. Reg. Section 1.482-1(b)(1)?

by Lewis J. Greenwald

Lewis J. Greenwald is a U.S. international tax partner with Sullivan & Worcester LLP in Boston.

The author would like to thank David H. Kaplan, a tax attorney with Sullivan & Worcester LLP, for his thoughtful reviews.

The *Xilinx* case has been quite a ride. First the Tax Court found that the Internal Revenue Code section 482 allocation (to include the cost of employee stock options (ESOs) in the cost pool of Xilinx's cost-sharing arrangement (CSA)) was "arbitrary and capricious."¹ Then the majority of the Ninth Circuit panel reversed the Tax Court decision, finding that: (i) the arm's-length requirement "in every case" of Treas. reg. section 1.482-1(b)(1) was irreconcilable with the "all costs" requirement of former Treas. reg. section 1.482-7(d)(1); (ii) that the more specific (former Treas. reg. section 1.482-7(d)(1)) controls the more general (Treas. reg. section 1.482-1(b)(1)); and (iii) that the Ireland-U.S. income tax treaty did not change that result by virtue of the treaty's savings clause.²

In response to the Ninth Circuit's decision, on August 12, 2009, Xilinx filed a petition for rehearing or a rehearing *en banc*. Many groups (including former Treasury and IRS officials) and companies (including Cisco Systems Inc. and Apple Inc.) filed amicus briefs in support of Xilinx's petition. On October 6, 2009, the commissioner of Internal Revenue filed his response in opposition, and on October 13, 2009, Xilinx filed its reply. On January 13, 2010, the panel for the Ninth Circuit withdrew its original opinion, and on

March 22, 2010, the panel for the Ninth Circuit issued a revised opinion in which it affirmed the Tax Court's decision.³

After quickly reviewing the background of this case, this article reviews Xilinx's petition for rehearing, the commissioner's response in opposition, and the revised decision. This article concludes with some thoughts regarding the continuing conflict between Treas. reg. sections 1.482-1(b)(1) and former 1.482-7(d)(1) and a suggested tweak to Treas. reg. section 1.482-1(b) that might finally reconcile the "irreconcilable" and finally put to rest this epic struggle.

Background

In 1995, Xilinx and Xilinx Ireland (XI) entered into a CSA. Under the CSA, each party was required to pay a percentage of the total research and development costs in proportion to their anticipated benefits (commonly referred to as the "RAB shares"). However, Xilinx did not include ESO costs in the CSA's cost pool. The IRS issued notices of deficiency against Xilinx for 1997, 1998, and 1999, contending that the ESO costs should have been shared by Xilinx and XI under the CSA. The IRS's determination resulted in substantial

¹125 T.C. 27 (2005).

²567 F.3d 482 (9th Cir. 2009), Judge Noonan dissenting.

³105 AFTR 2d 2010-1490 (Mar. 22, 2010), Judge Reinhardt dissenting.

tax deficiencies and accuracy-related penalties under IRC section 6662(a). Xilinx timely filed suit in the Tax Court.

After a bench trial, the Tax Court found that two unrelated parties in a CSA would not share the costs related to ESOs. After assuming that ESOs were costs for purposes of former Treas. reg. section 1.482-7(d)(1), the Tax Court found dispositive Treas. reg. section 1.482-1(b)(1) (which required CSAs between related parties to reflect how two unrelated parties operating at arm's length would behave), and it concluded that the commissioner's allocation was arbitrary and capricious because it included the ESO costs in the CSA cost pool, even though two unrelated companies dealing with each other at arm's length would not share those costs. The commissioner timely appealed.

On appeal, the majority of the panel for the Ninth Circuit agreed that including ESO costs in the CSA cost pool was "simply not an arm's-length result" (as required by Treas. reg. section 1.482-1(b)(1)). However, the majority also agreed that the all-costs requirement of former Treas. reg. section 1.482-7(d)(1) required the sharing of those costs. Acknowledging that these provisions were "irreconcilable," the majority relied on the canon of construction that the specific rule (here, the all-costs rule of former Treas. reg. section 1.482-7(d)(1)) often controls the general rule (here, the arm's-length standard of Treas. reg. section 1.482-1(b)(1)). Also, the majority found that former Treas. reg. section 1.482-7(d)(1) does not conflict with the treaty (which embodies the arm's-length standard), because the savings clause of the treaty "allows a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty." Judge Noonan dissented.

Xilinx's Petition for Rehearing

On August 12, 2009, Xilinx filed a petition for rehearing or rehearing *en banc*. Xilinx opened its petition as follows:

This case involves the principle at the heart of a major area of federal and international tax law — "transfer pricing" in related-party transactions. The panel's divided decision presents an exceptionally important question: Whether this Court may apply a U.S. transfer-pricing regulation in a way that is "irreconcilable" with the "arm's-length" standard, when that standard has always been the statutory standard for taxation of such transactions under U.S. law; is the international norm, championed by the United States and embodied in numerous treaties; and is the only basis on which the government has ever defended the result it sought in this case.

Regarding the centrality of the arm's-length standard in U.S. transfer pricing law and U.S. tax treaties, Xilinx made two broad claims regarding the Ninth Circuit's decision:

- the majority's decision improperly abandoned the arm's-length standard as the statutory touchstone for U.S. transfer pricing law; and
- the majority's decision cannot be reconciled with the arm's-length provisions of U.S. income tax treaties.

Abandonment of the Arm's-Length Standard

Xilinx first observed that back in 1933, the Board of Tax Appeals had already found that the purpose of the predecessor to IRC section 482 was "to place transactions between related trades or businesses owned or controlled by the same interests upon the same basis as if such businesses were dealing at arm's length with each other,"⁴ and that "for decades," Treasury "has consistently embraced the arm's-length standard."⁵

Xilinx then observed that Treasury and the IRS had reorganized the "scope and purposes" provisions of the IRC section 482 regulations in 1993 "to make clear that the arm's-length standard is the guiding principle for all allocations under section 482."⁶ When Treasury finalized those regulations in 1994, it reiterated that "section 482 is concerned only with whether the taxpayer reports its true taxable income" in accordance with the arm's-length standard.⁷ Xilinx further noted that the final regulations are "unequivocal" on this point. Treas. reg. section 1.482-1(b)(1) unambiguously states:

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.

Xilinx then said that "Treasury has never varied from its position that the arm's-length standard applies to all transfer pricing, including cost sharing," and that "the government has never argued that Code section 482 permits any departure from the arm's-length standard."

⁴Citing *Comm'r v. First Sec. Bank of Utah*, 405 U.S. 394, 400, and 407 (1972) ("As stated in the Treasury Regulations, the 'purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer"); *DHL Corp. v. Comm'r*, 285 F.3d 1210, 1217 (9th Cir. 2002); *Kenco Restaurants, Inc. v. Comm'r*, 206 F.3d 588, 595 (6th Cir. 2000); *Barford v. Comm'r*, 194 F.3d 782, 787 (7th Cir. 1999).

⁵Citing Notice 88-123, 1988-2 C.B. 458 (commonly referred to as the "White Paper") (concluding that "the legal standard for determining arm's-length pricing" and that the arm's-length standard is the "accepted international norm" for transfer pricing adjustments) and the "1992 IRS Report on the Application and Administration of Section 482" (Apr. 10, 1992) ("The standard . . . the IRS applies in a transfer pricing case is the internationally accepted 'arm's-length' standard.').

⁶T.D. 8470, 1993-1 C.B. 90, Preamble.

⁷T.D. 8552, 1994-2 C.B. 93, Preamble.

Xilinx concluded this portion of its petition as follows:

The panel majority sustains the IRS's reallocation on a rationale *never advanced or defended by the government itself*, and [which is] completely at odds with decades of uniform administrative and judicial construction of Section 482.⁸ [Emphasis in original.]

The specific/general canon of construction cited by the majority — which, like any canon, is persuasive only when “there is no clear indication otherwise” — neither requires nor justifies that result. On the contrary, every indication is that Treasury has always correctly understood section 482 to require use of the arm's-length standard, and always intended its regulations to require arm's-length results. The majority's decision to sustain the IRS's reallocation after flatly rejecting its arm's-length rationale effectively unmoors U.S. transfer pricing law from what for decades has been its central statutory and theoretical principle. That fundamental and far-reaching error warrants *en banc* review.

The Majority's Decision Cannot Be Reconciled

Having concluded that the Ninth Circuit had abandoned the arm's-length standard as the statutory touchstone for U.S. transfer pricing law, Xilinx went on to argue that the Ninth Circuit had also inappropriately relied on the savings clause of the treaty to reach its decision. Xilinx provided four reasons why the Ninth Circuit should not have relied on the savings clause of the treaty:

- First, both the treaty itself and Treasury's contemporaneous, authoritative interpretation confirm that U.S. domestic law requires arm's-length treatment.
- Second, the majority ignored the fact that the 1949 Ireland-U.S. income tax treaty (which governs two of the three tax years at issue in the case) did not contain a comparable savings clause.
- Third, the majority did not consider the entire text of the treaty. Article 1(4) of the treaty states a general rule that each nation may tax its residents (including corporations) “as if the Convention had not come into effect.” Article 1(5) lists exceptions. These include articles 9(2) and 26, which together establish that when one nation reallocates income to a taxpayer based on a related-party transaction, the other related party may seek off-

setting relief — which the other nation has an obligation to grant, if it agrees that the reallocation produces an arm's-length result. In case of doubt, the competent authorities of the two nations “shall endeavour” to agree on, among other things, “the same allocation of income, deductions, credits, or allowances,” “with a view to the avoidance of taxation which is not in accordance with the Convention.”⁹

- Fourth, treaties, as agreements between countries, must be construed to effectuate the intent, expectations, and purposes of the parties.¹⁰

Xilinx also pointed out that the United States has ratified dozens of treaties with arm's-length provisions, without the slightest indication that saving clauses would permit either party's domestic law to depart from the arm's-length standard.

Xilinx concluded:

The majority's approach would effectively nullify the standard “associated enterprises”/“correlative adjustment” and “competent authority” provisions discussed above (articles 9(2) and 26). Ireland would have no obligation to accord XI an “appropriate adjustment” under article 9(2), offsetting the IRS's reallocation of income to Xilinx, because, as every judge to consider this case has agreed, the IRS's reallocation is not arm's-length. The United States, on the other hand, would presumably decline to reverse a reallocation sustained by a U.S. court. The result would be complete frustration of the treaty's arm's-length provisions and competent-authority mechanism.

This cannot possibly be how the saving clause, or the rest of the treaty, was intended to operate — or how the treaty partners understood the United States would apply domestic law.¹¹

In short, as Treasury has stressed, “overwhelming evidence” confirms that the arm's-length standard

⁹Citing article 26(3), and stating that:

The specific carve-out for these articles makes clear that the saving clause does not waive either nation's direct obligation to the other to apply the arm's-length standard in reallocating income between related parties covered by the treaty.

¹⁰Citing *United States v. Stuart*, 489 U.S. 353, 365-366 (1989); *Gonzalez v. Gutierrez*, 311 F.3d 942, 948 (9th Cir. 2002).

¹¹Citing the “1992 IRS Report on the Application and Administration of Section 482” (Apr. 10, 1992) 8 (acknowledging a treaty “obligation to apply the arm's length principle to residents of the treaty country” — here, XI); *South Dakota v. Yankton Sioux Tribe*, 522 U.S. 329, 348 (1998) (declining to “read the saving clause [of the treaty] in a manner that eviscerates the agreement in which it appears,” and holding that specific substantive language “governs the general' terms of the saving clause”).

⁸Citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947) (“[A] reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency.”).

is the international transfer pricing norm, “incorporated into all U.S. income tax treaties.” Yet the panel majority holds, *for the first time ever*, that U.S. law applies a different standard. That holding will create uncertainty and undercut the uniform international standard that Treasury has labored to establish. It is exceptionally important, and warrants further review. [Emphasis in original.]

The Commissioner’s Response

In its opposition brief, the commissioner made three arguments as to why Xilinx should not be granted a rehearing:

- the panel majority reached the correct result (albeit for the wrong reason);
- Xilinx’s claim of “exceptional importance” had been undermined by the subsequent changes to the cost-sharing regulation; and
- the case is not the proper forum for addressing whether the United States and Ireland (or any other treaty partner) have a common understanding of the arm’s-length principles contained in tax treaties.

The Correct Result (but for the Wrong Reason)

The commissioner noted that throughout the litigation he had argued that the 1986 addition of the commensurate-with-income requirement to IRC section 482, coupled with the lack of any indication that Congress intended that requirement to supplant the arm’s-length standard, required a reading of Treas. reg. section 1.482-1(b)(1) that “accommodates Congress’s view that the arm’s-length result is not invariably determined solely by reference to uncontrolled transactions.” The commissioner acknowledged that the majority had not agreed with this reasoning — finding instead that “the plain meaning of the term ‘arm’s-length result’ in that regulation did not permit such conclusion.” The commissioner noted, however, that the majority had acknowledged that regulators may adopt a technical definition of a term that is distinct from its plain meaning, but had been unwilling to conclude that the IRS had actually exercised that authority in the absence of explicit regulatory language to that effect.

All that said, the commissioner continued to argue that in light of the 1986 amendment of IRC section 482 and the issuance of the all-cost requirement of former Treas. reg. section 1.482-7(d)(1), the arm’s-length standard of Treas. reg. section 1.482-1(b)(1) “necessarily embodied the technical connotation that the panel majority acknowledged would have been dispositive had it been expressly set forth therein.” The commissioner continued:

By its very terms, the statutory commensurate-with-income requirement injects an element of economic analysis to U.S. transfer pricing law that is not grounded solely in comparison with

uncontrolled transactions. And the legislative history confirms that the requirement is intended to provide an internal benchmark for verifying that the putatively comparable uncontrolled transactions are in fact comparable.¹² This approach simply reflects Congress’s view that reference to purportedly comparable uncontrolled transactions that are not comparable transactions for these purposes cannot, by definition, produce an arm’s-length result. That is the “technical” limitation on the regulatory term “arm’s-length result” that the majority declined to read into the former regulations at issue.

The commissioner also noted that throughout the litigation he had argued that the “reasonably anticipated benefits” sharing requirement of former Treas. reg. section 1.482-7 is meaningless without the corresponding requirement that the cost-sharing participants share all development-related costs (including ESO costs), regardless of whether unrelated parties would do so. Said differently, if a cost-sharing participant were free to exclude certain development-related costs from the CSA cost pool, then by definition (unless the participants incurred the excluded costs in the exact proportion in which they shared the *included* costs), one participant’s share of aggregate development-related costs would exceed its proportionate share of anticipated profits, and the other participant’s share of anticipated profits would exceed its proportionate share of aggregate costs. “It follows that, in order to ‘produce results consistent with the changes made by the [1986] Act to royalty arrangements,’ the cost pool of a CSA must encompass *all* development-related costs.”¹³ [Emphasis in original.]

Claim of Exceptional Importance

The commissioner went on to note that the majority had expressly limited its analysis to the irreconcilability of Treas. reg. section 1.482-1(b)(1) and former Treas. reg. section 1.482-7(d)(1), and that a “clarifying” regulation had been issued on August 26, 2003 (which made it clear that ESO costs were to be included in a CSA cost pool).¹⁴ By virtue of this clarifying regulation, the commissioner argued that need for further review was not “urgent,” because the issue had been resolved for all tax years beginning on or after August 26, 2003. The commissioner also argued that Xilinx’s assertion (that the 2003 amendments merely reassert,

¹²Citing H.R. Rep. No. 99-426 at 425 (given the “extreme difficulties in determining whether the arm’s-length transfers between unrelated parties are comparable,” “it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation . . . be commensurate with the income attributable to the intangible.”).

¹³Quoting H.R. Conf. Rep. No. 99-841 at II-638.

¹⁴T.D. 9088, 2003-2 C.B. 841.

in regulatory form, the rejected position that ESO adjustments produce an arm's-length result) completely ignores the fact that Treasury and the IRS can (and did) "adopt a technical definition of a term that is distinct from its plain meaning."

In short, because the majority's rationale is founded on the terms of a former regulation that was materially (and, as the majority recognized, validly) modified in 2003, the panel's decision, far from involving an issue of exceptional importance, has little continuing significance.

Not the Proper Forum

Finally, the commissioner argued that the treaty-based arguments of Xilinx and the amici did not provide valid grounds for granting Xilinx a rehearing. The commissioner pointed out that the majority had correctly held that by virtue of the treaty's savings clause, the treaty has "no direct application to the instant dispute between the United States and a U.S. corporation."¹⁵ The commissioner acknowledged that article 1(5) of the treaty contains exceptions to the savings clause (including articles 26 and 9(2)), but argued that neither of these exceptions prevent the IRS from applying IRC section 482 in this case.

The commissioner also argued that Xilinx's assertion that the Ninth Circuit's decision may result in actions by U.S. treaty partners that could lead to double taxation was "purely speculative and, as such . . . plainly insufficient to warrant the granting of a hearing in this case." Further to that point, the commissioner said a treaty partner's reaction ("potential or otherwise") to the Ninth Circuit's decision is not an appropriate ground for rehearing.¹⁶

This is particularly so in this case, when any reaction by a treaty partner would focus not on whether the panel reached the right result under U.S. transfer pricing law — the only law at issue here — but rather on whether U.S. transfer pricing law (specifically, its incorporation of commensurate-with-income principles in the QCSA regulations) comports with the treaty partner's understanding of the arm's-length principle set forth in the relevant treaty.

¹⁵Citing Green, "Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes," 23 *Yale J. Int'l L.* 79, 131 and footnote 275 (1998) (referring to the standard saving clause in support of the observation that "for the most part, . . . tax treaties constrain only one aspect of taxation: the manner in which it applies to foreign persons.").

¹⁶Citing *Newdow v. U.S. Congress*, 328 F.3d 466, 470, (9th Cir. 2003) cert. denied, 540 U.S. 962 (2003) rev'd sub nom. *Elk Grove Unified School District v. Newdow* 542 U.S. 1 (2004) (Reinhardt, J., concurring in the order denying rehearing *en banc*) (decrying the notion that a case should be reheard based on the "public and political reaction" to the panel decision).

On October 13, 2009, Xilinx filed its reply brief, and on January 13, 2010, the Ninth Circuit withdrew its original opinion.

The Revised Opinion

On March 22, 2010, the Ninth Circuit issued a revised opinion.¹⁷ In the revised opinion, Judge Fisher joined Judge Noonan in affirming the Tax Court's decision that the commissioner's allocation was arbitrary and capricious; Judge Reinhardt now dissented.

For the Majority, Judge Noonan

Like his dissent in the original opinion, Judge Noonan began his discussion by pointing out the irreconcilability of Treas. reg. section 1.482-1(b)(1) (which requires that the arm's-length standard be applied in every case) and former Treas. reg. section 1.482-7(d)(1) (which required that all costs be shared in a CSA). "Each provision's plain language mandates a different result." Given the ambiguity created by these related provisions, Judge Noonan identified two possible choices:

- apply a rule of thumb that the specific controls the general; or
- resolve the ambiguity based on the dominant purpose of the regulations.

Regarding the first choice (the basis of the original opinion), Judge Noonan reiterated much that he had written in his original dissent:

The first alternative is a simple solution. It is plausible. But it is wrong. It converts a canon of construction into something like a statute. . . . Apply this simple rule here, and section 1.482-7(d)(1) controls. The conflict dissolves. The Commissioner is vindicated. . . . This 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 "tools designed to help courts better determine what Congress intended, not to lead courts to interpret the law contrary to that intent."¹⁸

In light of these principles, Judge Noonan found that two considerations showed the commissioner's position to be "untenable." First, he found that purpose is paramount:

The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If

¹⁷105 AFTR 2d 2010-1490 (Mar. 22, 2010), Judge Reinhardt dissenting.

¹⁸Citing *Scheidler v. National Org. of Women, Inc.*, 547 U.S. 9, 23 (2006).

the standard of arm's length is trumped by section 1.482-7(d)(1), the purpose of the statute is frustrated.

Second, Judge Noonan noted that the arm's-length standard of the treaty "aids in understanding the mind and practice of the Treasury." Judge Noonan noted that U.S. tax treaties are negotiated by the United States with the active participation of Treasury and that Treasury's reading of a treaty is "entitled to great weight."¹⁹ Also, simultaneous with the signing of the treaty, Treasury issued its technical explanation. Regarding article 9 of the treaty, the Treasury explanation provides:

This article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provision, particularly Code section 482.²⁰

Regarding article 9 of the treaty, Judge Noonan argued:

We do not, however, need to decide in this case whether the treaty obligations 'constitute binding federal law enforceable in United States courts.'²¹ It is enough that our foreign treaty partner and responsible negotiators in the Treasury thought that arm's length should function as the readily understandable international measure.

Judge Fisher's Concurrence

The reversal of the Ninth Circuit was made possible by Judge Fisher's concurrence with Judge Noonan (in the original decision Judge Fisher had sided with Judge Reinhardt in overturning the Tax Court's decision). Judge Fisher switched sides for two reasons:

- in his opposition brief, the commissioner had supported the Ninth Circuit's conclusion but not its reasoning in reaching that conclusion; and
- Xilinx's understanding (that ESO costs should not be included in a CSA cost pool) "was widely shared in the business community and tax profession."

Judge Fisher wrote:

Having thoroughly considered not only the plain language of the regulations but also the various interpretive tools the parties and amici have brought before us, including the legislative history of section 482, the drafting history of the regulations, persuasive authority from international tax

treaties²² and what appears to have been the understanding of corporate taxpayers in similar circumstances and of others,²³ I conclude that Xilinx's understanding of the regulations is the more reasonable even if the Commissioner's current interpretation may be theoretically plausible. Traditional tools of statutory construction do not resolve the apparent conflict in these regulations as applied to Xilinx, and the Commissioner's attempts to square the "all costs" regulation and the arm's-length standard have only succeeded in demonstrating that the regulations are at best ambiguous.²⁴ . . . Indeed, I am troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them.²⁵

Judge Reinhardt's Dissent

In his dissent, Judge Reinhardt said he continued to believe that "as a matter of law, the 'all costs' regulation, as the specific of the two provisions, the one designed to deal specifically with the type of question before us, controls." As such, Judge Reinhardt continued to believe that the Tax Court decision should be

²²"I agree that the 1997 United States-Ireland Tax Treaty, along with the Treasury's Technical Explanation, although not addressing the specific regulatory conflict at issue here, is evidence that Xilinx's understanding of the arm's length standard was and is quite reasonable. The treaty, and others like it, reinforce the arm's length standard as Congress' intended touchstone for section 482."

²³Citing Brief of PricewaterhouseCoopers LLP, Deloitte Tax LLP, and KPMG LLP as Amici Curiae on the Petition for Rehearing at 5-6 (describing a "global consensus"); Brief of Cisco Systems Inc. and 32 Other Affected Companies as Amici Curiae on the Petition for Rehearing at 3 (describing "settled business expectations"); cf. brief of former U.S. Treasury and IRS officials at 3-5.

²⁴"The dissent invokes the prior, withdrawn majority opinion. Dissent at 4613-14m see *Xilinx, Inc. v. CIR*, 567 F.3d 482 (9th Cir. 2009), *withdrawn* January 13, 2010. In writing that opinion, I was persuaded that the arm's-length standard and the all costs regulation were in conflict, and that the more specific of the two should control. See 567 F.3d at 486. I no longer share Judge Reinhardt's confidence in that resolution *because the Commissioner's response to Xilinx's petition for rehearing declined to fully endorse its reasoning*. Instead, the thrust of the Commissioner's response was that our *result* was correct, even though the reasoning was not." [Emphasis added.]

²⁵Judge Fisher noted 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 the case. Citing 26 C.F.R. section 1.482-7T(a) and (d)(1)(iii) (2009) (stating that ESOs are costs that must be shared and that the all-costs requirement is an arm's-length result).

¹⁹Citing *United States v. Stuart*, 489 U.S. 353, 369 (1989) (quoting *Sumitomo Shoji America, Inc. v. Aragliano*, 457 U.S. 176, 184-185 (1982)).

²⁰Citing also article 9 of the France-U.S. income tax treaty, of the Germany-U.S. income tax treaty, and of the U.K.-U.S. income tax treaty.

²¹Citing *Medellin v. Texas* 522 U.S. 491 (2008).

reversed. That said, it is interesting that Judge Reinhardt (like Judge Fisher) was troubled by the commissioner's lack of support of the Ninth Circuit's reasoning in its original opinion:

I, like Judge Fisher, am less than enthusiastic about the Commissioner's explanation of how he believes we should resolve this case. His preference is that we find somehow that the arm's length standard is met by way of the all costs requirement. I must confess that I have difficulty following his reasoning and, like Judge Fisher, am not persuaded by that argument. However, the Commissioner then says that if we still believe that the provisions are in conflict, we must apply the rule on which Judge Fisher originally relied and on which I continue to rely. I guess I am just not as sensitive as Judge Fisher. Simply because the Commissioner advanced an argument that we reject, but then argued that if we reject it, we should apply the rule that we held applicable in our opinion is hardly a reason for abandoning the rule that we believed to be correct. We can't expect anyone, let alone the Commissioner of the Internal Revenue, to agree completely with everything we say. Rejecting the Commissioner's first argument leaves us exactly where we were before he advanced it: The two regulations are in conflict, and (as Judge Fisher and I once agreed) that conflict must be resolved by applying the specific regulation rather than the general one.

Final Thoughts

As noted above, the *Xilinx* case has been quite a ride. In light of the Ninth Circuit's revised opinion, the question arises: Where are we now? At this late date most would agree that:

- the U.S. and international transfer pricing standard is the arm's-length standard;
- third parties acting at arm's length do not share ESO costs when they enter into CSAs;
- the IRS believes that ESO costs should be shared when related parties enter into CSAs; and
- the IRS has the authority to write regulations that require ESO costs to be shared by related parties when they enter into CSAs.

What is not so clear is whether Treas. reg. section 1.482-1(b)(1) and Treas. reg. section 1.482-7T(d)(1) continue to be in conflict.²⁶ The Ninth Circuit did not answer that question.

Today, Treas. reg. section 1.482-1(b)(1) still states:

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 party. [Emphasis added.]

Treas. reg. section 1.482-7T(d)(1)(iii) (as amended in 2009) provides in relevant part:

For purposes of this section, IDCs [intangible development costs] means all costs, in cash or in kind (including stock-based compensation . . .), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of the CSA that based on analysis of the facts and circumstances, are directly identified with, or reasonably allocable to the IDA [intangible development activity].

In fact, notwithstanding the successive amendments to Treas. reg. section 1.482-7(d)(1), the two regulations continue to be in conflict. The "to be applied in every case" language of Treas. reg. section 1.482-1(b)(1) is irreconcilable with the requirement that stock-based compensation be included in a CSA pool because (as everyone now agrees), third parties to a CSA would not share such costs.

With a view to promoting fairness and certainty in the administration and compliance of our U.S. federal income tax law, Treasury and the IRS should now consider tweaking Treas. reg. section 1.482-1(b)(1) to eliminate the continuing conflict. One possible tweak to Treas. reg. section 1.482-1(b)(1) might be as follows:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case (*except as specifically set forth in Treas. Reg. Sec. 1.482-7 with respect to a qualified cost sharing arrangement as described therein*) is that of a taxpayer dealing at arm's length with an uncontrolled party. [Emphasis added.]

Such a tweak might finally put to rest this epic struggle. ♦

²⁶On August 29, 2005, the Treasury and IRS issued proposed amendments to the CSA Regulation; on January 6, 2009, those proposed regulations were issued in temporary form.