

March 24, 2010

## Court Addresses (Again!) Employee Stock Option Expenses for Transfer Pricing Purposes

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### **Ninth Circuit Reverses Itself and Holds that the Arm's-Length Standard Controls in Determining if Employee Stock Option Expenses Must Be Shared Among Related Parties Under Pre-2003 US Transfer Pricing Rules**

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#### **SUMMARY**

In a major taxpayer victory, the US Court of Appeals for the Ninth Circuit, in *Xilinx, Inc. v. Comm'r* (2010 U.S. App. LEXIS 5795 (March 22, 2010)), reversed its earlier decision and affirmed the Tax Court's decision that the arm's-length standard controls in determining whether employee stock option ("ESO") expenses in cost sharing agreements related to developing intangibles are subject to transfer pricing. The Court of Appeals upheld the Tax Court's determination that unrelated parties jointly developing intangibles and transacting on an arm's-length basis would not include ESO expenses in a cost sharing agreement, and therefore such expenses are not subject to reallocation under pre-2003 US transfer pricing rules. The new decision is a dramatic reversal of the Ninth Circuit's prior decision in May 2009 (which decision had been withdrawn on January 13, 2010) that related companies sharing expenses of developing intangibles (such as intellectual property) must share costs attributable to ESOs (and thus, must share any deductions associated with such costs) even if such sharing would be inconsistent with the arm's-length standard that generally governs transfer pricing rules under US tax law and under US international tax treaties. A discussion of the earlier Court of Appeals decision can be found in our prior publication, entitled "Court Addresses Employee Stock Option Expenses for Transfer Pricing Purposes," available at <http://sullcrom.com/publications> or by following the instructions at the end of the publication.

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The new decision by the Court of Appeals is particularly significant for multinational taxpayers, especially those taxpayers involved in high technology or similar businesses that have substantial operations conducted through foreign subsidiaries. Many businesses, as a matter of practice, did not allocate to non-US subsidiaries the costs of stock-based compensation issued by a US parent on the basis that unrelated parties transacting on an arm's-length standard would not share such costs. Instead, the US parent would claim the full amount of stock-based compensation costs as deductible business expenses on its US tax returns. Reallocation of a portion of these expenses to a foreign subsidiary, as would have been required under the withdrawn Court of Appeals decision, would have effectively reduced the amount of deductible and creditable business expenses available to the US parent and deferred the benefit of those deductions until such time as the related income was repatriated from the foreign subsidiary to the US through a distribution or otherwise.

As a technical matter, the *Xilinx* decision applies to a prior version of the Treasury Regulations that were amended in 2003. The post-2003 Treasury Regulations explicitly require reallocation of stock-based compensation expenses to offshore subsidiaries. However, the *Xilinx* decision will have direct impact on many companies involved in ongoing transfer pricing disputes with the IRS for pre-2003 taxable years. Indeed, the *Xilinx* case has been of great interest to the business community and tax practitioners, several of whom expressed their concerns through amicus briefs, which appear to have been given serious consideration by the Court of Appeals.

Beyond the impact on pre-2003 taxable years, the *Xilinx* decision has significant ramifications because it upholds the supremacy of the arm's-length standard as the principal standard for transfer pricing determinations. The Court of Appeals decision is based on the principle that the arm's-length standard trumps transfer pricing requirements that are inconsistent with the arm's-length standard, because the primary purpose and intent of the US transfer pricing rules is to put related parties on tax parity with unrelated parties, or, in other words, to conform related party transactions to the arm's-length standard. The fact that the US Treasury Department has espoused the primacy of the arm's-length standard in its Technical Explanations of US international tax treaties was also given serious weight by the court.

An interesting question that remains unanswered is to what extent the Court of Appeals decision calls into question current US Treasury Regulations that require cost sharing even where the costs are not shared by unrelated parties transacting on arm's-length terms. The concurring opinion notes that it is an "open question" as to whether current Treasury Regulations (amended in 2003) adequately address the ambiguity and inconsistency at the heart of the *Xilinx* case.

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## BACKGROUND

### 1. Cost Sharing Provisions Under Code Section 482

Code Section 482 authorizes the IRS to adjust and allocate income, deductions and other tax items among related parties in order to prevent tax evasion and to reflect the proper allocation of income among

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related parties. The regulations under Code Section 482 generally require related party transactions and arrangements to conform to an arm's-length standard. Under the relevant Treasury Regulations in question, the IRS would adjust tax items with respect to a qualified cost sharing arrangement relating to the development of intangibles only to the extent necessary to make each participant's share of all costs of intangible development equal to such participant's share of reasonably anticipated benefits attributable to the development. In 2003, the Treasury Department amended these regulations to provide that stock-based compensation must be counted as a cost of developing intangibles and would therefore be subject to transfer pricing adjustment under these rules. However, the question before the court in *Xilinx* is the treatment of these expenses under the rules as they were in effect from 1997 to 1999, before this amendment.

### 2. The Prior *Xilinx* Decisions

The *Xilinx* case involves a US corporate taxpayer that researched, developed, manufactured, marketed and sold integrated circuit devices and related development software systems. The taxpayer established an Irish subsidiary, Xilinx Ireland ("XI"), in 1994, and the taxpayer and XI entered into a cost sharing agreement in 1995 providing joint ownership of any new technology developed by either XI or the taxpayer. This agreement did not specifically address whether expenses attributable to ESOs issued by the taxpayer would constitute a cost to be shared under the agreement. In 1996, the taxpayer and XI entered into two agreements to allow XI employees to acquire options for the taxpayer's stock. The agreements provided that XI would pay the taxpayer for the "cost" of the exercise of the stock options, in an amount equal to the spread between the stock's market price on the exercise date and the exercise price. XI made such payments to the taxpayer in the taxable years in question from 1997 to 1999.

The ESOs issued by the taxpayer during the relevant tax years consisted of incentive stock options ("ISOs"), nonstatutory stock options ("NSOs"), and employee stock purchase plan shares ("ESPPs"). An employee is generally taxed on the spread between the fair market value and the exercise price of NSOs on exercise but is only taxed on ISOs and ESPPs if the employee sells the stock in certain "disqualifying dispositions." Employers such as the taxpayer receive a corresponding deduction when the employees recognize income. Accordingly, from 1997 to 1999, the taxpayer claimed deductions for amounts attributable to its employees' exercises of NSOs and disqualifying dispositions of ISOs and ESPPs. The taxpayer also claimed R&D credits based in part on these expenses.

The IRS disallowed a portion of the deductions claimed by the taxpayer and imposed accuracy-related penalties on the basis that the taxpayer should have shared the ESO expenses with XI under the cost sharing agreement to the extent the ESOs were issued to employees involved in or supporting R&D activities. By shifting a portion of these costs to XI, the IRS, in effect, significantly reduced the amount of expenses deductible by the taxpayer and taken into account for purposes of determining the taxpayer's R&D credits. The deductions would instead be allocable to XI, and any benefit from the deductions would generally be deferred until XI's related income is repatriated to the US (by dividend or otherwise).

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### a. The Tax Court Decision

The taxpayer challenged the IRS's determination in the Tax Court on the grounds that the ESO expenses in question were not "costs" for this purpose as unrelated parties transacting on arm's-length terms would not share ESO-related costs. The Tax Court held in favor of the taxpayer and held that the arm's-length standard was controlling, and therefore, ESO costs would be subject to transfer pricing only if unrelated companies under an arm's-length standard would share such costs. The Tax Court found that such costs would not be shared under an arm's-length standard, based on evidence and testimony from experts that, in practice, unrelated companies do not explicitly share such costs and that, further, unrelated parties would not want to share such costs as the valuation of this cost would be difficult to calculate, would be unpredictable and subject to significant fluctuation, and would lead to perverse incentives—for example, the cost-sharing partner would have a perverse incentive to diminish the stock price of its joint venture partner in order to minimize the spread-based cost that it would have to bear. The IRS also conceded that unrelated parties would not share ESO-related costs.

### b. The Original Court of Appeals Decision

On appeal, the Ninth Circuit found that the regulatory provision requiring the arm's-length standard to be applied "in every case" was inconsistent and irreconcilable with the regulatory provision that required related parties to share "all" costs of intangible development in proportion to their share of reasonably anticipated benefits from such development (the "all-costs requirement"). The court concluded that the bright-line rule under the all-costs requirement addressed a particular type of related party transaction—intangible product development—and that, with respect to such transactions, the specific bright-line rule overrode the general arm's-length standard requirement. The court also held that the all-costs requirement did not violate the Ireland-US Tax Treaty, which designates the arm's-length standard as the appropriate standard for determining whether related party transactions would be subject to transfer pricing adjustments. The court concluded that the treaty was not violated, because the treaty's saving clause reserves the ability of Ireland or the US to apply its domestic law to its own citizens and residents even if such laws conflict with the treaty. On January 13, 2010, the Court of Appeals withdrew this decision in anticipation of the new opinion discussed below.

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## THE NEW NINTH CIRCUIT DECISION

The new opinion by the Court of Appeals echoes the Tax Court decision and the earlier Court of Appeals decision in finding that the arm's-length standard requirement is irreconcilable with the all-costs requirement. However, the court rejected the earlier Court of Appeals decision's holding that the specific all-costs requirement should control when conflicting with the general arm's-length standard requirement. The court here instead held that, while it is a canon of construction in textual interpretation that a specific rule trumps the general rule where the two conflict, this is just one among many interpretative tools and is

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not binding on the court, particularly when other evidence is available that shows the intent and purpose of the rules in question.

According to the court, the purpose of the transfer pricing regulations is to achieve tax parity between related party transactions and unrelated party transactions. In order to reach this conclusion, the court relied on the fact that the Treasury Department's Technical Explanation of the Ireland-US Tax Treaty explicitly refers to the arm's-length principle in describing US domestic transfer pricing provisions under Code Section 482. Accordingly, the court found that the intent and purpose of the regulatory provisions is to impose the arm's-length standard as the controlling standard for transfer pricing purposes and that therefore, to the extent the all-costs requirement conflicts with the arm's-length standard, the arm's-length standard prevails. The court reasoned that if the arm's-length standard is trumped by the all-costs requirement, then the purpose of the regulatory provisions to impose an arm's-length standard is frustrated because the taxpayer would not have tax parity with an independent taxpayer who would not share such costs with an unrelated party.

It is interesting to note that the concurring opinion was issued by one of the judges who had found in favor of the IRS in the earlier Ninth Circuit decision. In explaining his change of opinion, the judge took issue with the IRS's response to the taxpayer's appeal of the earlier Ninth Circuit decision. In its response, the IRS argued that the result of the earlier decision was correct but not the reasoning, because the arm's-length standard and the all-costs requirement were not actually in conflict. Instead, the IRS argued that the all-costs requirement was a gloss on the arm's-length standard to address a situation in which there is no comparable transaction between unrelated parties to which the related parties may conform. According to the concurring opinion, the IRS contended that the economic situation of related parties would be materially different from that of unrelated parties, because related parties would be less concerned about exposing themselves to each other's fluctuations in stock price since the related parties are already exposed to such fluctuations by virtue of their common ownership. The concurring opinion found that this argument for reconciling the two provisions was too complex and theoretical, rendering the regulatory provisions ambiguous and unfair to taxpayers who were not given clear, fair notice of how the regulations would affect them.

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