IRS Acquiesces in Xilinx Decision but only for Pre-2003 Cases

IRS Acquiesces in the Result (but Not the Reasoning) of Ninth Circuit Holding that Employee Stock Option Expenses Need Not Be Shared Among Related Parties Under Pre-2003 US Transfer Pricing Rules

SUMMARY

In an "action on decision" (IRS AOD 2010-03) (the “AOD”) issued on July 28, 2010, the IRS acquiesced in the result (but not the reasoning) of Xilinx, Inc. et al. v. Commissioner, 598 F.3d 1191 (9th Cir. 2010) (“Xilinx”) for taxable years beginning prior to August 26, 2003. In Xilinx, the US Court of Appeals for the Ninth Circuit, reversing its earlier decision, upheld the supremacy of the arm’s-length standard for transfer pricing by holding that employee stock option (“ESO”) expenses in cost-sharing agreements related to developing intangible property are not subject to reallocation under then applicable US transfer pricing rules, because unrelated parties jointly developing intangibles and transacting on an arm’s-length basis would not include ESO expenses in such a cost-sharing agreement. For a fuller discussion of the Court of Appeals decisions, please see our prior publications, entitled “Court Addresses Employee Stock Option Expenses for Transfer Pricing Purposes,” and “Court Addresses (Again!) Employee Stock Option Expenses for Transfer Pricing Purposes,” available at http://sullcrom.com/publications or by following the instructions at the end of this publication.

The Xilinx decision applies to a prior version of the Treasury Regulations ("pre-2003 Regulations") that were amended in 2003. The post-amendment Treasury Regulations ("post-2003 Regulations") explicitly require inclusion of stock-based compensation expenses in a cost-sharing agreement while the pre-2003 Regulations did not. Even though the direct impact of Xilinx and the AOD is on companies involved in ongoing transfer pricing disputes with the IRS for taxable years beginning prior to August 26, 2003, Xilinx has potentially significant impact beyond such taxable years because the 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. Accordingly, the decision could be read to invalidate any transfer pricing requirement that is perceived to be inconsistent with the arm’s-length standard, and under such a reading, it is possible that the post-amendment Treasury Regulations would be invalidated as they require related parties to share stock-based compensation costs even where such costs are not shared by unrelated parties transacting on arm’s-length terms. Indeed, the concurring opinion in *Xilinx* noted that it is an “open question” as to whether the current Treasury Regulations adequately address the perceived ambiguity of the rules and the inconsistency between the arm’s-length standard and the all-costs-sharing requirement.

Perhaps in order to quell such speculation, the IRS issued the AOD stating that the IRS “believes that the Ninth Circuit opinion is erroneous” but that the IRS accepts the result of the Ninth Circuit decision while rejecting the court’s reasoning. The IRS explains that it accepts the result only because the amendment of the Treasury Regulations moots the impact of the Ninth Circuit decision. The amended rules explicitly require ESO expenses and other stock-based compensation be included in cost-sharing agreements for developing intangibles. The IRS also reaffirms its prior litigating position that the arm’s-length standard is consistent with the requirement that “all” costs of developing intangibles be shared under a cost-sharing agreement, even where parties transacting on arm’s-length terms may not share such expenses.

**BACKGROUND**

1. The Relevant Transfer Pricing Rules Under Code Section 482

Code Section 482 rules authorize the IRS to adjust and allocate income, deductions and other tax items among related taxpayers in order to prevent tax evasion and provide the proper allocation of income among related parties. In general, under these rules, the pricing of related party transactions and arrangements is required to conform to an arm’s-length standard. With respect to qualified cost-sharing agreements relating to the development of intangibles, under the pre-2003 Regulations, the IRS was authorized to adjust tax items 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, these regulations were amended to provide that stock-based compensation must be counted as a cost of developing intangibles and therefore subject to transfer pricing adjustments under these rules. *Xilinx* addresses the treatment of these expenses prior to the amendment of the rules in 2003.

2. Prior *Xilinx* Decisions

In *Xilinx*, the taxpayer, a US corporation, established an Irish subsidiary, Xilinx Ireland (“XI”), with whom it entered into a cost-sharing agreement providing joint ownership of any new technology developed by either XI or the taxpayer. This agreement did not specifically provide whether expenses attributable to ESOs issued by the taxpayer would constitute a cost to be shared by the parties. The taxpayer claimed deductions related to its ESO expenses and also claimed R&D credits based in part on these expenses from 1997 to 1999.
The IRS disallowed a portion of these deductions 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. In effect, by shifting a portion of these costs to XI, the IRS significantly reduced the amount of expenses that were deductible by the taxpayer and taken into account for purposes of determining the taxpayer’s R&D credits. Any benefit from the deductions reallocated to XI would generally be deferred until XI’s related income is repatriated to the US (e.g., by dividend).

a. The Tax Court Decision

The taxpayer challenged the IRS’s determination in the Tax Court on the grounds that unrelated parties transacting on arm’s-length terms would not share ESO-related costs and therefore the ESO expenses in question were not subject to reallocation under the pre-2003 Regulations. The Tax Court agreed with the taxpayer that the arm’s-length standard was controlling and that, therefore, ESO costs would be subject to transfer pricing adjustment only if unrelated companies under an arm’s-length standard would share such costs. Based on evidence and testimony from experts that, in practice, unrelated companies do not explicitly share such costs and would not want to share such costs for a variety of commercial reasons, the Tax Court found that such costs would not be shared under an arm’s-length standard. (The IRS also conceded that unrelated parties would not share ESO-related costs, although in the AOD, the IRS downplays the significance of this concession and contends that it was misinterpreted by the Ninth Circuit.) Accordingly, the Tax Court held in favor of the taxpayer.

b. The Ninth Circuit Decisions

On appeal, in its first decision, a Ninth Circuit split panel 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 of Appeals held that, under the principle that a specific rule trumps the general rule where the two conflict, the specific all-costs requirement overrode the general arm’s-length standard with respect to intangible development transactions.

The taxpayer petitioned for rehearing or rehearing en banc. The taxpayer was supported by numerous amici briefs that affirmed the importance of the arm’s-length standard. On January 13, 2010, the Court of Appeals withdrew its earlier decision, and on March 22, 2010, the Ninth Circuit issued its new *Xilinx* decision. The new opinion by the Court of Appeals agreed with the Tax Court and the earlier Court of Appeals’ decision that the all-costs requirement is inconsistent and irreconcilable with the arm’s-length standard requirement. However, the court rejected the earlier Court of Appeals’ holding that the specific all-costs requirement should control when conflicting with the general arm’s-length standard requirement.

Instead, the Court of Appeals held that, to the extent the all-costs requirement conflicts with the arm’s-length standard, the arm’s-length standard overrides the all-costs requirement, because the intent and
purpose of the transfer pricing rules is to achieve tax parity between related party transactions and unrelated party transactions and to impose the arm's-length standard as the controlling standard for transfer pricing purposes. To hold otherwise, according to the Court of Appeals, would thwart the purpose of the regulatory provisions to impose an arm's-length standard, because the taxpayer would not have tax parity with a taxpayer who would not share such costs with an unrelated party.

The IRS declined to seek certiorari to the Supreme Court. An open question under the Ninth Circuit's second decision is whether the Court of Appeals' reasoning would similarly invalidate the 2003 amendment of the regulations that provides that stock-based compensation must be taken into account as a cost of developing intangibles for transfer pricing purposes.

**IRS ACTION ON DECISION**

On July 28, 2010, the IRS issued an action on decision in *Xilinx*, acquiescing in the result but not the reasoning of the Court of Appeals' holding. Accordingly, the IRS will apply the Ninth Circuit's holding to cost-sharing agreement transactions governed by the pre-2003 Regulations. The IRS explains that it is accepting the result of the court's decision only because the impact of the Ninth Circuit's decision is mooted by the post-2003 Regulations, which, according to the AOD, make clear that a cost-sharing agreement produces an arm's-length result if, and only if, each party bears its share of all intangible development costs, including ESO and other stock-based compensation costs.

According to the AOD, the IRS maintains its prior litigating position that the arm's-length standard and the all-costs requirement are consistent. The IRS contends in the AOD that if two parties are entering into an agreement to acquire interests in intangible property and one party failed to bear the full share of costs in developing the property (e.g., by not bearing such party's share of ESO-related expenses), the other party would have overpaid for its interest in the intangible property and would not have entered into such an arrangement. On that basis, the IRS states that the joint ventures on which the Tax Court based its factual finding that unrelated parties do not share ESO expenses are not comparable to cost-sharing arrangements covered by the post-2003 Regulations. However, the AOD reiterates that the IRS position in such circumstances does not require restructuring related party transactions to conform to a transaction unrelated parties would have entered into on arm's-length terms; rather, the actual transaction entered into by related parties is to be respected, so long as it has economic substance. The arm's-length standard of the Code Section 482 regulations applies not to "restructure the actual transaction to which controlled taxpayers engage, but to adjust pricing to an arm’s-length result." Accordingly, the arm's-length standard would be applied to determine the appropriate amount that should have been paid and an appropriate transfer pricing adjustment would be made to compensate for the underpayment.
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August 2, 2010
LONDON:383614.5