OFFICE OF THE CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Amended
IRB No. 2010-33
August 16, 2010

ACTION ON DECISION

Subject: Xilinx, Inc. v. Commissioner, 598 F.3d 1191 (9th Cir. 2010), aff'g, 125 T.C. 37 (2005).

Issue:

Whether the Ninth Circuit Court of Appeals erred in concluding that under regulations promulgated under section 482 effective for taxable years 1997-1999, employee stock-option (ESO) compensation should not be shared in a qualified cost sharing arrangement (CSA).[1]

Summary:

The Internal Revenue Service (Service) believes the Ninth Circuit's opinion is erroneous and acquiesces in the result, but not the reasoning, of the decision with respect to ESOs granted in taxable years governed by the section 482 regulations in effect prior to their amendment in 2003. The Service acquiesces in the result only for such ESOs because the significance of the Ninth Circuit's opinion is mooted by the 2003 amendments made to Treas. Reg. §§ 1.482-1(b)(1) and 1.482-7(d). T.D. 9088, 2003-2 C.B. 841.

Facts and Background:

Xilinx and its wholly owned subsidiary, Xilinx Ireland, entered into a CSA that required each party to make appropriate payments under Treas. Reg. § 1.482-7(g) and pay a percentage of the total research and development (R&D) costs in proportion to its reasonably anticipated benefits (RAB) from the technology to be developed pursuant to the CSA. Xilinx and Xilinx Ireland (collectively, "Taxpayer") granted ESOs to their employees. The CSA did not contain a provision that specifically addressed the treatment of ESOs. Taxpayer did not include amounts related to ESOs in the R&D costs shared in the CSA, but claimed section 162 business expense deductions and

[1] Unless otherwise specified, all citations and section references are to the Internal Revenue Code and the Treasury regulations thereunder as in effect during tax years 1997, 1998, and 1999.

section 41 R&D credits in connection with the ESOs. After an audit, the Service issued notices of deficiency for tax years 1997, 1998, and 1999 on the basis that ESOs are costs for purposes of Treas. Reg. § 1.482-7(d) that Taxpayer must share. Xilinx filed a petition in the United States Tax Court.

After extensive summary judgment briefing, trial, and post-trial briefing, the Tax Court held that, assuming ESOs were costs, unrelated parties in a CSA would not agree to share ESO costs or would share such costs on the basis of financial accounting "intrinsic value"[2] and, therefore, the Service's adjustment was arbitrary and capricious because it did not comply with the arm's length standard of Treas. Reg. § 1.482-1(b)(1). Xilinx, Inc. v. Commissioner, 125 T.C. 37, 62-63 (2005). The Service appealed.

A Ninth Circuit split panel initially reversed the Tax Court, holding that even though it considered that Treas. Reg. §§ 1.482-1(b)(1) and 1.482-7(d)(1) provide conflicting standards, Treas. Reg. § 1.482-7(d)(1) controls as the more specific regulatory provision. The split panel held that, because that provision required the sharing of "all costs," and because ESOs are an intangible development cost (IDC), participants to a CSA must share the cost of ESOs. Xilinx, Inc. v. Commissioner, 567 F.3d 482, 489, 495, and 496 (9th Cir. 2009, withdrawn Jan. 13, 2010). Xilinx petitioned for rehearing or rehearing en banc, on the basis of the primacy of the arm's length standard, and was supported by numerous amici briefs that attested to the importance of the arm's length standard, but did not universally reject the outcome of the Ninth Circuit's initial opinion. In its response, the Service supported the outcome of the original Ninth Circuit opinion, but did not agree with Taxpayer's or the Ninth Circuit's interpretation of the arm's length standard. The Service did agree however that the arm's length standard applied to the case.

As a result of Xilinx's petition for rehearing, the Ninth Circuit withdrew its original opinion on January 13, 2010, and filed a new opinion on March 22, 2010, affirming the Tax Court. In a split decision by the same panel, the Ninth Circuit majority (Majority)

[2] The intrinsic value method of accounting values stock-based compensation based on the excess of the stock's market price on the grant date over the exercise price, which in the case of ESOs issued by Xilinx would result in a $0 value because it issued its ESOs "at the money" (i.e., exercise price equals the stock's market price on the date of grant). During the tax years subject to the litigation, SFAS 123 governed the treatment of ESOs for financial accounting purposes. SFAS 123 added the "fair value" method as the preferred method for valuing stock based compensation, but allowed companies to use the intrinsic value method if they disclosed in a footnote the income results using the fair value method. FASB issued SFAS 123-R in 2004, which requires that all share-based payment transactions be recognized in financial statements and measured based on the fair value method. The fair value method requires valuing the stock-based compensation using an option pricing model, such as the Black-Scholes formula.

resolved what it perceived as contradictory regulations by holding that the arm's length standard of Treas. Reg. § 1.482-1(b)(1) precluded the sharing of ESO costs in a CSA as required by Treas. Reg. § 1.482-7(d)(1). Xilinx, Inc. v. Commissioner, 598 F.3d 1191, 1196 (9th Cir. 2010).

Discussion:

The Service agrees with each member of the Ninth Circuit panel insofar as they concluded that the "all costs" language of Treas. Reg. § 1.482-7(d) would require controlled participants to a CSA to share the cost of ESOs. The Service also agrees that ESOs awarded to employees performing R&D are costs related to the intangible development area, as the majority of the Ninth Circuit concluded in the initial opinion.[3] Finally, the Service agrees that under general principles of administrative law, the Secretary of the Treasury is authorized to define terms adopted in regulations, especially when they are neither present nor compelled in statutory language (such as the arm's length standard), that might differ from the definition others would place on those terms. See, e.g., Xilinx, 567 F.3d 482, 491, n.9.

The Majority, however, mistakenly interprets the arm's length standard to limit the behavior of controlled taxpayers, or the transactions into which they may enter, based on the behavior or transactions into which uncontrolled taxpayers may or may not enter.[4] To the contrary, the regulations accept the controlled taxpayers' actual transaction, provided it has economic substance.[5] The regulatory arm's length standard asks what would have been the pricing that uncontrolled taxpayers would have adopted, had they entered into the same transaction in which the controlled taxpayers actually engaged. In other words, the regulations define what is the pricing, as determined under the best method rule, of the actual controlled transaction that produces an "arm's length result."[6]

---

[3] Although this issue was not reached in the subsequent Ninth Circuit opinion, the Service finds no indication in the revised opinion that the Ninth Circuit would reach a different conclusion.

[4] While the Service agrees that U.S. income tax treaties incorporate the same arm's length standard as under the section 482 regulations, the Service considers Treas. Reg. § 1.482-7, as in effect both prior to and subsequent to its amendment by T.D. 9088, to be consistent with the regulatory arm's length standard and, therefore, with the treaties. The Service does not agree with the Majority (or amici) to the extent they may imply otherwise.

[5] Treas. Reg. § 1.482-1(d)(3)(ii)(B) and (f)(2)(ii)(A).

[6] Treas. Reg. § 1.482-1(b)(1) and (c)(1) state in pertinent part:

> A controlled transaction meets the arm's length standard if the results of the transaction are

In a CSA, a controlled taxpayer acquires a percentage interest in the intangibles developed pursuant to the CSA referred to as the reasonably anticipated benefits or RAB share.[7] The controlled taxpayer's RAB share is the controlled taxpayer's portion of the total benefits reasonably anticipated from all interests in the intangibles developed pursuant to the CSA. As payment for this interest, the price the controlled participant must bear is its RAB share of all intangible development costs (IDCs) incurred to develop the intangibles pursuant to Treas. Reg. § 1.482-7(a) and (d).[8] Under the realistic alternatives principle, this price is also the price that produces an arm's length result for purposes of Treas. Reg. § 1.482-1(b)(1). As an economic matter, a person who co-develops intangibles would not be willing to bear a share of development costs that is disproportionately greater than the share of benefits to be derived from that person's interest in the to-be-developed intangibles, absent additional compensation to account for the disproportionate sharing of costs relative to benefits. Rather, the co-developer will seek out other, better opportunities or partners. At the limit, this person may prefer not to engage in a cost sharing transaction at all, than to be undercompensated by bearing a disproportionate share of the costs relative to the benefits of the enterprise. Under the section 482 regulations, this fundamental economic principle – that an uncontrolled taxpayer will not choose an alternative that is less economically rewarding than another available alternative – applies not to restructure the actual transaction in which controlled taxpayers engage, but to adjust pricing to an arm's length result.[9] Thus, if a controlled taxpayer fails to bear its RAB

> consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). . . .
>
> The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

[7] Treas. Reg. § 1.482-7(f)(3)(i).

[8] If a controlled taxpayer makes available pre-existing intangible property for purposes of research in the intangible development area, the buy-in for such pre-existing intangibles represents another element (in addition to the sharing of IDCs) of the arm's length consideration in connection with the controlled taxpayer's entering into the CSA. Treas. Reg. § 1.482-7(g)(2).

[9] Treas. Reg. § 1.482-1(f)(2)(ii)(A) provides in pertinent part:

> [T]he [Commissioner] may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the [Commissioner] may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the

share for all the IDCs, including ESO costs, the acquisition of such intangible interest is underpriced and does not reflect an arm's length result. Such controlled taxpayer would realize a share of the income (or loss) attributable to the intangibles that is disproportionately larger than is justified by the price it pays for its interest, contrary to the clear reflection of income required by section 482.[10]

Accordingly, contrary to the Ninth Circuit's view, the provisions under Treas. Reg. §§ 1.482-1(b)(1) and 1.482-7 are mutually consistent and the sharing of all costs, including ESO costs, under a CSA conforms to the arm's length standard.[11] The significance of the Ninth Circuit's erroneous interpretation is mooted, however, by amendments to the regulations in 2003 by T.D. 9088. Those amendments make clear that a CSA produces an arm's length result within the meaning of Treas. Reg. § 1.482-1(b)(1) if, and only if, each controlled taxpayer bears its RAB share of all IDCs, including ESO and other stock-based compensation costs, and that Treas. Reg. § 1.482-7

---

alternative had been adopted by the taxpayer.

[10] The Majority leaves a misimpression about the Service's position by the paraphrase that "[t]he Commissioner does not dispute the tax court's factual finding that unrelated parties would not share ESOs as a cost." Xilinx, 598 F.3d 1191, 1194. In footnote 5 of Appellant's brief, the Service stated that it was "not appealing the Tax Court's factual finding that uncontrolled parties dealing at arm's length in a joint venture to develop intangibles would not share the cost of compensatory stock options and purchase rights issued to the parties' respective employees." (Emphasis added.) The Service considered that fact finding irrelevant to the arm's length standard. As explained above, the arm's length standard inquires into the pricing that uncontrolled taxpayers would have adopted had they engaged in a transaction that is the same or similar to the transaction in which the controlled taxpayers actually engaged. In the Service's view, the joint ventures before the Tax Court were not the same or comparable to CSAs, so do not provide evidence of an arm's length result, whether or not the joint venture partners shared ESOs.

[11] The Treasury regulations, of course, implement the direction in the legislative history:

> In revising section 482, the conferees do not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such arrangements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost sharer would be expected to bear its portion of all costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development stages would be included. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development.

H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-638 (1986) (emphasis added).

provides the only method to be used to evaluate whether a CSA produces results consistent with an arm's length result.[12] In light of this clarification, the Service will apply the result of the Ninth Circuit's decision to ESOs granted in taxable years governed by the regulations in effect prior to the 2003 amendments.

[Remainder of this page intentionally left blank]

[12] Treas. Reg. §§ 1.482-1(b)(2)(i) and 1.482-7(a)(3) (T.D. 9088).

Recommendation: Although the Service believes the Ninth Circuit's opinion is erroneous, the Service acquiesces in the result of the decision with respect to employee stock options granted in taxable years governed by the section 482 regulations in effect prior to their amendment in 2003 because the significance of the Ninth Circuit's opinion is mooted by the 2003 amendments to Treas. Reg. §§ 1.482-1(b)(1) and 1.482-7(d)).

Joseph P. Dewald
Assistant to the Branch Chief, Branch 6
Associate Chief Counsel
(International)

Reviewers:

Approved:

CHRISTOPHER B. STERNER
Deputy Chief Counsel (Operations)
Internal Revenue Service

By: _____

Steven A. Musher
Associate Chief Counsel
(International)