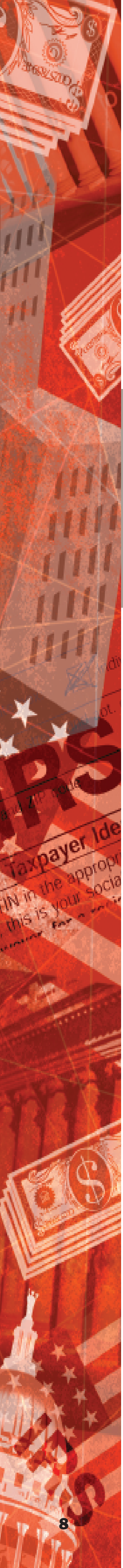

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Xilinx, Uncertainty, and the Meaning of Arm's Length

The Tax Court's decisions about cost-sharing arrangements in the Xilinx cases and the reactions from the IRS have added to the controversy and debate surrounding the definition and application of the arm's-length concept.

The *Xilinx* decisions (*Xilinx v. Comm.*, 125 TC 37 (2005), *Xilinx v. Comm.*, 567 F3d 482 (Ninth Circ. 2009), *Xilinx v. Comm.*, 2010-1 U.S.T.C. ¶50,302 (Ninth Circ. 2010)) have been the source of considerable controversy over a period of several years and have far-reaching implications for the future of transfer pricing. At the core of *Xilinx* is the question as to whether related parties engaging in a cost-sharing arrangement must share the costs associated with stock options issued to their research scientists. In Xilinx's case, sharing the costs would have moved deductions out of the U.S. and into Xilinx's Irish subsidiary, raising U.S. taxable income. In the initial decision, the Tax Court concluded that because there is evidence that uncontrolled parties wouldn't share such costs, related entities should be able to avoid such cost sharing.

The decision was then appealed to the Ninth Circuit, which reached the controversial conclusion that the specific Treasury regulation (requiring that "all costs" in a cost-sharing arrangement be shared) effectively overrode the more general regulation (requiring the arm's-length standard be met). The Court believed that unrelated parties didn't share stock-option costs—that is, sharing wasn't arm's length—but that the regulations relating to cost-sharing arrangements required such sharing in any case. In essence, this decision radically undermined the arm's-length standard that has been the dominant benchmark in transfer pricing throughout OECD (Organisation for Economic Co-operation and Development) countries. Following the wave of controversy that the decision generated, the Ninth Circuit withdrew its original decision in January 2010, ultimately replacing it with a decision affirming the Tax Court's position. The new decision emphasized that the cost-sharing regulations and the general transfer pricing arm's-length standard were irreconcilable; that is, the regulations required some behaviors that weren't arm's length. But the Court concluded that the dominant purpose of the regulations was decisive. According to the Court, the dominant purpose is parity between controlled and uncontrolled taxpayers (the arm's-length standard). On that basis, the controlled parties didn't need to share stock option costs. This represents a major shift from the earlier decision, which specifically noted that the goal isn't to achieve arm's length, per se, but rather to prevent tax evasion via income manipulation.

The IRS's response to its defeat in *Xilinx* is both interesting and important. Rather than appeal, the IRS acquiesced in the result—but not the reasoning—of *Xilinx*. In its Action on Decision of July 28, 2010, the IRS elaborated on its concerns with the Ninth Circuit's reasoning. A strong statement came in the form of its comment that the Court's "erroneous interpretation is mooted, however, by [subsequent] amendments to the regulations." These regulations now specifically state that a cost-sharing arrangement will only meet the arm's-length requirement of Reg. §1.482-1(b)(1) if "all costs, in cash or in kind (including stock-based compensation)" are appropriately shared. Essentially, the regulations now explicitly embrace the Treasury view that arm's length requires stock options to be shared (irrespective of what independent parties might do).

In contrast to the IRS, commentators such as Charles W. Cope and Thomas M. Zollo have suggested that the decision of the Ninth Circuit has in fact provided an argument for rendering the 2009 regulations invalid ("The Ninth Circuit Affirms the Tax Court's Decision in Xilinx, But Some Issues Remain Unresolved," *Tax Management International Journal*, 2010, pp. 344-346). The reasoning for this argument is that, because the Court specifically found that arm's length isn't practiced to share stock option costs, then a regulation that specifically defines arm's length as necessitating such sharing can be valid. Unfortunately, the only real outcome has been uncertainty: The IRS believes that the new regulations have rendered *Xilinx* of little or no practical value while many commentators believe that *Xilinx* has rendered the regulations invalid.

What's clear is that there is a very dramatic disconnect between the IRS's interpretation of arm's length and the interpretation adopted by many commentators. This will ultimately lead to disagreements that result in lengthy court cases. The IRS and commentators such as Cope and Zollo have argued that the meaning of arm's length has evolved over time and now incorporates a formulaic dimension—that is, it expressly dictates certain practices as being arm's length, like requiring stock options to be included in cost-sharing arrangements. Other commentators adhere to the more traditional arm's-length standard defined in the general transfer pricing regulations as placing controlled and uncontrolled parties on tax parity—that is, if independent parties don't do something, then it isn't arm's length.

We make three points. First, we believe that the new regulations are likely to be found valid because of the result in *Mayo Foundation for Medical Education & Research v. United States* (131 S. Ct. 704, 2011), which suggests that the Court won't disturb a rule developed by an agency with the authority to do so unless such a rule is clearly contradictory to the statute. It's well understood by commentators that the arm's-length standard isn't a part of a statute; the term "arm's length" only appears in the Treasury Regulations, and, as the Ninth Circuit's original position noted, the purpose of 26 USC §482 isn't to achieve arm's length but to prevent tax evasion through income shifting. In fact, that law specifically states that the Secretary may make a reallocation "in order to prevent evasion of taxes or clearly to reflect the income." We emphasize prevention of evasion through income shifting, but other commentators, such as Cope and Zollo, have also identified a possible challenge to the regulations on the basis of the lower threshold of clear reflection of income.

The IRS's decision not to appeal *Xilinx* leaves much ambiguity with regard to the meaning of arm's length.

Second, although Treasury is likely to succeed in the stock options case, the IRS's decision not to appeal *Xilinx* was a mistake because it leaves so much ambiguity with regard to the meaning of arm's length. It also represents a move away from a principles-based approach to a rules-based approach. The Treasury and IRS may win the debate on stock options, but they will need to continue to draft more and more detailed and specific rules in order to combat each new development that slips through the existing arm's-length net. Given the vast ambiguity of transfer pricing and intangible assets, this is going to be a monumental task.

Third, the IRS position regarding stock options ultimately appears to be the correct one and is consistent with earlier OECD analysis on the treatment of stock options. The IRS ultimately argued that independent parties don't share option costs because they don't make agreements like the ones that are made between related parties. Thus, it isn't valid to make this comparison. The 2004 OECD report, *Cross-border Income Tax Issues Arising from Employee Stock-Option Plans,* equates employee remuneration and stock options. Failing to include options in any measure that incorporates employee remuneration—for example, cost-plus pricing—must, by construction, introduce a distortion in pricing. For example, if we took the extreme position that scientists of one party were compensated entirely in options, would it be reasonable for the second party to the agreement to share none of those costs despite the fact that the labor contribution clearly added significant value to the intangible development?

The controversy surrounding *Xilinx* appears to be far from over. Although the debate in *Xilinx* was about stock-option costs and whether they should be included in cost-sharing agreements, the philosophical issues run much deeper and go to the heart of the meaning of arm's length. The IRS decision not to appeal *Xilinx* is likely to prove disadvantageous in the long run and will force the U.S. Treasury Department into an increasingly rules-based approach. The position of the Tax Court and the Ninth Circuit seem equally problematic and potentially place the United States at odds with its OECD partners. A better solution would probably have been to resolve the meaning of arm's length at the court level, thus preserving a principles-based approach to the arm's-length concept, which is widely viewed as the global standard. **SF**

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