

IRS Loses Major International Tax Case: Ninth Circuit Changes Course, Affirms Decision in *Xilinx*

March 23, 2010

In a decision filed on March 22, the U.S. Court of Appeals for the Ninth Circuit reversed course and affirmed the U.S. Tax Court's decision in favor of the taxpayer in *Xilinx, Inc. v. Commissioner of Internal Revenue*. *Xilinx* is perhaps the most closely watched tax case of the last decade. The Ninth Circuit had previously decided in favor of the Internal Revenue Service (IRS), but after a flood of criticism from the tax community, the court subsequently withdrew its opinion.¹

The decision is a significant victory for taxpayers and a major loss for the IRS. The opinion affirms the primacy of the arm's length standard as a foundation of the United States' transfer pricing regime and rejects the IRS's attempt to interpret its own rules in conflict with the arm's length standard. In this regard, the case once again calls a broader issue to the forefront—whether IRS's current cost sharing regulations at Treas. Reg. § 1.482-7T, which were specifically designed to rewrite the arm's length standard in the context of cost sharing arrangements, constitute an abuse of the IRS's regulatory authority.

The appellate case in *Xilinx* involved whether the expense associated with employee stock options must be shared by parties to a cost sharing arrangement. The Ninth Circuit found that there was a conflict in the applicable regulations: Treas. Reg. § 1.482-1(b)(1) provides that the standard to be applied in every case is that of parties acting at arm's length, while Treas. Reg. § 1.482-7(d)(1) states that *all* costs must be shared, regardless of whether unrelated parties would share those costs. The conflict arose because the taxpayer presented evidence at trial that unrelated parties would not in fact share any amounts associated with stock option expense.²

The central issue involved in resolving the conflict, as framed by Judge Noonan writing for the majority, was whether the court should rule that the specific provision (regarding costs that must be shared) overrules the general regulation (regarding the arm's length standard) or whether the court should rule consistent with the purpose of the regulations. The court chose the latter.

¹ Read more about the Ninth Circuit's previous decision in our January 13, 2010 LawFlash, "Cautious Optimism as Ninth Circuit Withdraws *Xilinx* Decision," available at http://www.morganlewis.com/pubs/Tax_XilinxDecision_LF_13jan10.pdf.

² The Ninth Circuit did not address the issue of whether amounts associated with stock option expense were in fact "costs."

The opinion states that the purpose of regulations is “paramount.” The purpose of the regulations at issue, the court observed, is tax “parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions.” The court found that this purpose would be frustrated if the IRS were permitted to trump the arm’s length standard in certain circumstances. In particular, the court noted that “[i]f Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.”

In addition, the court looked to the tax treaty between the United States and the Republic of Ireland for purposes of determining the Treasury Department’s “mind and practice,” and found that the Technical Explanation to the treaty refers to section 482 of the Internal Revenue Code as reflecting the arm’s length standard. Because the purpose of the section 482 regulations is to place related parties at arm’s length, the IRS cannot be permitted to override this rule with a specific rule reaching a non-arm’s length result. Query the impact of this theory with respect to the IRS’s “platform intangible” concept as reflected in Temp. Treas. Reg. § 1.482-7T.

In an interesting concurrence, Judge Fisher (whose vote changed from the earlier decision) noted that Xilinx’s interpretation of the regulations led to a conflict in the regulations, whereas the IRS’s interpretation viewed the regulations as consistent. Nonetheless, Judge Fisher believed that Xilinx’s interpretation was “more reasonable” and was specifically “troubled by the complex, theoretical nature” of the IRS’s arguments. Judge Reinhardt dissented on many of the same grounds that gave rise to the Ninth Circuit’s original decision, which was written by Judge Fisher.

The Ninth Circuit’s opinion will have a dramatic impact on virtually all transfer pricing issues, regardless of whether those issues involve cost sharing. The majority’s opinion specifically found that there was a conflict in the regulations and that the arm’s length standard controlled. Thus, much to the IRS’s chagrin, evidence of what unrelated parties actually do will remain a staple of any section 482 analysis.

The Ninth Circuit’s decision also curtails the IRS’s ability to promulgate rules³ in the transfer pricing arena mandating a certain result without due consideration for what unrelated parties actually do. Arm’s length results cannot be achieved by fiat. Taxpayers now have a strong arrow in their quivers with which to respond to adjustments that are not based on actual transactions between unrelated parties.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any one of the following members of the Morgan Lewis Tax Practice:

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³ Or, further, to mandate a certain result on audit before such rules are promulgated, then promulgate them as a “clarification.”

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