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Ninth Circuit Reverses Tax Court on Including Stock Option Costs in Cost-Sharing Agreement: A Tale of Two Regulations

June 2009
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On May 27, in a 2-1 panel decision, the Ninth Circuit Court of Appeals reversed the United States Tax Court in *Xilinx, Inc. v. Commissioner* and remanded on two specific issues. The Ninth Circuit held that, under Treasury Regulations in effect during 1997 – 1999, related companies engaged in a joint venture to develop intangible property must include the value of certain employee stock option compensation in the pool of costs to be shared under a cost sharing agreement, even if companies operating at arm's length would not do so. Barring a successful petition for rehearing or petition for *certiorari* to the Supreme Court, this will become the rule for litigation in the Tax Court for taxpayers whose appeals lie to the Ninth Circuit, but not for other taxpayers for whom the Tax Court holding is still valid. The Ninth Circuit also remanded the case to the Tax Court (i) to determine whether the IRS's proposed allocation of costs accurately reflects stock option costs for employees involved in the joint venture and (ii) to determine whether accuracy-related penalties are appropriate.

The taxpayer, Xilinx, and its Irish subsidiary had entered into a cost sharing agreement which provided that each party was required to pay a percentage of the research and development costs for jointly owned technology. The agreement was silent as to whether the cost of employee stock options would be shared. Xilinx issued stock options to its employees, and claimed certain deductions with respect to the options.[1]

The IRS claimed that the amount deducted with respect to the options should have been shared with the Irish subsidiary, thereby reducing Xilinx's deduction and increasing its taxable income. The Tax Court held for the taxpayer, based on Treas. Reg. § 1.482-1(b)(1), which requires that agreements between related parties reflect how two unrelated parties operating at arm's length would behave. The Tax Court found that two unrelated companies operating at arm's length would not have shared these option costs. This factual finding was not challenged by the IRS on appeal.

On appeal, the Ninth Circuit characterized the case as requiring a choice between two irreconcilable regulations. The Ninth Circuit recognized the general and absolute language in § 1.482-1(b)(1), which requires that the arm's length standard be used "in every case" in which the IRS seeks to reallocate the income, deductions or credits between controlled parties under Section 482 of the Internal Revenue Code. The Ninth Circuit then described Treas. Reg. § 1.482-7(d)(1) as the "all costs requirement," which was imposed on every cost sharing agreement relating to intangible product development and required that controlled parties share all costs relating to intangible product development in a qualified cost sharing agreement. After reviewing the regulatory framework and appealing to the canon of construction which says that the specific governs over the general, the Ninth Circuit held that Treas. Reg. § 1.482-7(d)(1) controlled as that regulation dealt specifically with cost sharing arrangements, and that Treas. Reg. § 1.482-7(d)(1) required that all costs be included without exception. The Court held, therefore, that related companies in a cost sharing agreement to develop intangibles must share all costs related to the joint venture, *even if uncontrolled parties would not do so.* In the view of the majority, the fact that there was separate regulatory action addressing cost sharing agreements lent support to the conclusion that the requirement of including all costs was different from the generally applicable arm's length standard. The Court opined that achieving an arm's length result is not itself the regulatory regime's goal: rather, it viewed the purpose as preventing tax evasion by ensuring that taxpayers accurately reflect taxable income. The majority further determined that the regulation it applied did not conflict with the United States-Ireland Tax Treaty because the treaty allows a contracting state to apply its domestic laws to its own residents, and Xilinx was a domestic entity.[2]

The majority's analysis, however, does not follow a more fundamental rule of construction, namely, harmonization: "Where one statute deals with a subject in general terms, and another deals with a part of the same subject in a more detailed way, the two should be harmonized if possible; but if there is any conflict, the latter will prevail." *See* Norman J. Singer, Sutherland on Statutory Construction § 51.05. *See also Nat'l Cable & Telecomm. Ass'n, Inc. v. Gulf Power Co.*, 534 U.S. 327, 335–36 (2002). This requires first a consideration of how the provisions work together in the overall statutory and regulatory framework. In this regard, the "all costs requirement" should be read as a part of the determination of the appropriate arm's length allocation of costs between *controlled* taxpayers, *i.e.*, taxpayers who are presumptively not acting at arm's length, and this construction would satisfy the instruction to harmonize the provisions. Such a harmonization could be supported through inspection of the order of the Treasury Regulations, in which the body of section 482 regulations is described within the context of Treasury's acknowledgment that "[s]ection 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer." Instead, the Court opted to conclude that the regulations were irreconcilable and that, therefore, the specific rule governed. In so doing, the Court rejected a literal reading of the 'arm's length' standard as the pricing (or range of prices) that would be used by unrelated parties and embraced the government's argument that the price should be based on the underlying deduction of the option costs by the taxpayer.

The Court's holding has potentially interesting ramifications and might be used to reach a taxpayer-favorable result. For example, if a taxpayer allocated intangible property development costs in a way that is contrary to what uncontrolled parties would do at arm's length but which increases the tax basis in the intangible property of a U.S. taxpayer because of the inclusion of additional costs, the IRS presumably would have no recourse to the arm's length standard so as to reallocate such costs. In addition, in light of the Court's conclusion that ISO and ESPP expenses are "costs," the possible methods for including such costs for purposes of the Section 41 credit and Section 174 expense should be considered. Regarding the characterization of ISO and ESPP exercises as 'operating expenses' within the meaning of Treas. Reg. § 1.482-5(d)(3), the Court noted that the IRS stipulated that these exercises were not operating expenses and, therefore, that it was not considering whether these exercise 'costs' should be shared.

The Court found that the option costs in question were costs related to the joint venture for intangible product development, but only to the extent that the employees were involved in activities that related to the joint venture. The case was remanded to the Tax Court to determine whether the expenses disallowed were so limited. The Court also stated that on remand the Tax Court could consider defenses Xilinx raised against the application of penalties, noting its doubts that imposing a penalty was appropriate.

The regulations under Section 482 of the Internal Revenue Code were amended in 2003 to expressly provide that the costs which must be shared in a qualified cost sharing arrangement include the deduction claimed with respect to stock based compensation and to provide rules for measuring the associated cost. *See* Treas. Reg. § 1.482-7T(d)(1)(iii). Whether a challenge to the validity of this regulation based on its rejection of the arm's length principle will ever be made is difficult to say, but that is clearly the effect of the amended regulation, as well as the effect of the Ninth Circuit's decision.

[1] Xilinx claimed deductions upon the exercise of nonqualified options and on the "disqualifying disposition" of shares acquired on the exercise of incentive stock options ("ISOs"). The Court's decision applied to these deductions, and also to deductions claimed on the "disqualifying disposition" of shares acquired pursuant to an employee stock purchase plan ("ESPP"). The IRS did not assert that the exercise (as opposed to disqualifying disposition) of incentive stock options or the purchase of stock pursuant to the employee stock purchase plan gave rise to costs that must be shared.

[2] The dissent would have applied the general arm's length standard, based, among other things, on the dominant purpose of the regulations and the principle that ambiguous documents should be interpreted against the drafter, as well as repeated recourse in the Treaty to the arm's length standard in determining appropriate adjustments between "associated enterprises," *i.e.*, controlled parties.