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Ninth Circuit Issues Opinion in Key Transfer Pricing Case: Arm's Length Standard Vindicated

By Joseph K. Fletcher, III and Edward L. Froelich

On March 22, the Ninth Circuit issued its opinion affirming the opinion of the United States Tax Court in *Xilinx, Inc. v. Commissioner*. The March 22 ruling, a 2-1 panel decision written by Judge Noonan, relied heavily upon the Treasury Regulations under Section 482 and drew support from the U.S.-Ireland Tax Treaty and the Department of Treasury Technical Explanation thereto. Judge Fisher wrote a concurring opinion, while Judge Reinhardt dissented.

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. 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 taxpayer provided evidence that unrelated parties would share the cost of such stock-based compensation with unrelated parties. 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 Ninth Circuit reached this point in a circuitous manner. On May 27, 2009, in a 2-1 panel decision, the Ninth Circuit Court of Appeals reversed the Tax Court 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. Judge Noonan dissented from this Ninth Circuit opinion. The majority held that the "all costs requirement" of Treas. Reg. § 1.482-7(d)(1) was in conflict with 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 "in every case." The majority relied upon a rule of statutory construction that the specific governs the general and so concluded that the "all costs requirement" regulation trumped the general arm's length requirement set forth in Treas. Reg. § 1.482-1(b)(1).

We expressed the view in our Alert of June 3, 2009 that the May 27 Opinion was not well reasoned. http://www.mofo.com/news/updates/files/15647.html. Aside from points of statutory construction, the most significant concern arising from the May 27, 2009 Opinion was that it indicated, arguably in dicta, that the arm's length standard is not the central unifying principle of transfer pricing. Not only does this run counter to the Regulations promulgated under Section 482 and the terms of the U.S.-Ireland Tax Treaties in issue (the years at issue spanned a period during which an older U.S.-Ireland Tax Treaty was terminated and a new U.S. - Ireland Tax Treaty became effective), this runs contrary to the express intention of Treasury, as set forth in the Department of Treasury Technical Explanation to the U.S.-Ireland Tax Treaty and the long-standing effort by the Department of Treasury to establish the arm's length standard as the worldwide principle upon which transfer pricing is based.

Following the May 27, 2009 Opinion, the taxpayer filed a brief requesting a rehearing. In addition, numerous amicus briefs were filed requesting a rehearing and noting errors in the May 27 Opinion. On January 13, 2010, the Ninth Circuit issued an order withdrawing the May 27, 2009 Opinion.

The March 22 Opinion's analysis is rather brief. The main conclusion is not that there is an irreconcilable conflict between the two regulations, but that their apparent conflict creates an ambiguity regarding what is the standard for determining which costs must be shared in an intangibles CSA. This is an interesting maneuver around what had been described as a "winner takes all" conflict between the two pertinent regulations. It allowed the majority to appeal to a reading of the regulations which comports with the purpose of the regulations versus a mechanical application of the specific versus general rule of construction. The majority reasoned that the purpose of both the regulations and the statute would be undermined by allowing the all costs regulation to trump the arm's length standard. It then supported its view by referencing the U.S-Irish Tax Treaty enshrinement of the arm's length standard and concluded that the standard of interpretation which applies is the arm's length standard. Though the majority opinion did not specifically state, it suggested that the all costs regulation must be applied so as to allow for the operation of the arm's length principle rather than holding that the all costs regulation is invalid.

While the March 22 Opinion addresses regulations no longer in effect, in footnote 4 of the concurring opinion Judge Fisher suggests that the current regulations may not be valid. This footnote provides,

> It is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case. See 26 C.F.R. § 1.482-7T(a) & (d)(1)(iii) (2009) (stating explicitly that ESOs are costs that must be shared and that the all costs requirement is an arm's length result).

Both Judge Fisher and Judge Reinhardt appeared unimpressed with the Government's last-hour attempt on brief to harmonize the all costs requirement of Treas. Reg. § 1.482-7(d)(1) with the arm's length standard. Judge Fisher's note suggests such an attempt may not be possible despite the ipse dixit of the Government in the new regulations. This presents a tempting avenue for taxpayers in the Ninth Circuit who wish to challenge the current regulations.

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