BDO

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS: INTERNATIONAL TAXATION

SUBJECT

U.S. TAX COURT DECISION ON XILINX

OVERVIEW

On March 22, 2010, the United States Court of Appeals for the Ninth Circuit reversed its previously withdrawn opinion in the *Xilinx* case, deciding this time in favor of the taxpayer.[1] In the original tax dispute, the Internal Revenue Service issued a notice of deficiency against semiconductor company Xilinx, Inc. for its taxable years 1997, 1998, and 1999, contending that cost-sharing payments between the agreement participants should have included costs of employee stock options issued to employees participating in research and development activities. On August 30, 2005, the Tax Court found in favor of the taxpayer on the grounds that two unrelated parties in a cost-sharing agreement would not share costs related to employee stock option awards.[2]

The Service appealed, and on May 27, 2009, the court of appeals reversed the Tax Court's decision. The central issue in the appeal was which of two requirements would prevail: either i) Treas. Reg. § 1.482-7(d)(1), which provides that "all costs" be shared between related parties in a cost-sharing agreement; or ii) Treas. Reg. § 1.482-1(b)(1), which requires that the standard for evaluating transactions be what happens between parties transacting at arm's length. The court originally ruled in favor of the former requirement, thereby requiring that the costs of relevant stock option awards be cost-shared.

Xilinx petitioned for a rehearing of the case. After the parties submitted their briefs, the court withdrew its original opinion and issued another opinion on March 22, 2010, this time finding in favor of Xilinx. The new decision affirms the original Tax Court determination that related companies in cost-sharing arrangements do not need to allocate employee stock option expenses

Read more

[1] *Xilinx, Inc. v. Comm'r*, 567 F.3d 482 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010), *and replaced*, No. 06-74246, 2010 U.S. App. LEXIS 5795 (9th Cir. Mar. 22, 2010).
[2] *Xilinx, Inc. v. Comm'r*, 125 T.C. 37 (2005).

CONTACT:

ROBERT C. PEDERSEN
New York
212-885-8000 - rpedersen@bdo.com

J. SCOTT HENDON
Dallas
214-969-7007 - shendon@bdo.com

WILLIAM F. ROTH, III
Grand Rapids
616-774-7000 - wfroth@bdo.com

DON JONES
San Jose
408-352-1978 - djones@bdo.com

BYRON D. LAMBERT
Atlanta
404-979-7147 - blambert@bdo.com

CHRISTOPHER J. GALUPPO
New York
212-885-8000 - cgaluppo@bdo.com

IAN NOVOS
Los Angeles
310-557-0300 - inovos@bdo.com

HOLLY L. CARMICHAEL
San Jose
408-278-0220 - hcarmichael@bdo.com

between them because companies dealing at arm's length do not do so, based on the evidence presented.[3] One judge stated that the Service's "attempts to square the 'all costs' regulation with the arm's length standard have only succeeded in demonstrating that the regulations are at best ambiguous."[4] The new decision indicates that any ambiguity in the regulations must be construed in favor of the arm's length standard. This decision is significant because it restores the primacy of the arm's length standard.

Although the court's decision challenges the validity of transfer pricing regulations related to stock-based compensation, and thus could have a great impact on transfer pricing issues down the road, it is unlikely to change the current state of the United States transfer pricing regime any time soon. The regulations under which *Xilinx* was litigated did not specifically mandate the inclusion of stock-based compensation. Treas. Reg. § 1.482-7, as amended in August 2003, specified that all stock-based compensation relating to the development of intangibles under a qualified cost-sharing arrangement must be allocated between the participants, effective for taxable years beginning on or after August 26, 2003. Current Temp. Reg. § 1.482-7T, containing the new temporary cost-sharing regulations effective January 5, 2009, reinforces the requirement of allocation of stock-based compensation between the cost sharing agreement participants. In addition, the final section 482 regulations on controlled services transactions require inclusion of "stock based compensation" in the total costs of rendering services.[5] Nonetheless, the tension between the requirement to include "all costs" and the requirement that the standard for evaluating related party transactions be what prevails between unrelated parties is sure to result in further consideration of these issues in the courts.

---

[3] It is worth noting that, as the reissued decision states, "The Commissioner does not dispute the tax court's factual finding that unrelated parties would not share ESOs [employee stock options] as a cost." *Xilinx*, 2010 U.S. App. LEXIS 5795, at *8. The Commissioner instead argued that related parties in a cost-sharing agreement do not sit in similar enough circumstances to unrelated parties in a cost-sharing agreement to draw conclusions about what should prevail in a related party arrangement.
[4] *Xilinx*, *supra*, fn. 1 (Fisher, J., concurring).
[5] Treas. Reg. § 1.482-9, T.D. 9456, 74 Fed. Reg. 38,830 (Aug. 4, 2009).

The Tax Practice at BDO is among the largest tax advisory practices in the United States. With 37 offices and more than 400 independent alliance firm locations in the United States, BDO has the bench strength and coverage to serve you.

BDO is the brand name for BDO Seidman, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,138 offices in 115 countries.

BDO Seidman, LLP, a New York limited liability partnership, is the U.S. member of BDO International

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

Copyright © 2010 BDO Seidman, LLP