Cooley

March 29, 2010

In a stunning reversal of its previous opinion in *Xilinx, Inc. v. Commissioner,* the U.S. Court of Appeals for the Ninth Circuit held on March 22, 2010 that stock option compensation costs need not be shared by participants in a cost sharing arrangement where such costs would not be shared at arm's length between unrelated parties. In its highly controversial prior opinion, the Ninth Circuit had held on May 27, 2009, that Xilinx's stock option compensation was subject to cost sharing, even if such costs would not be shared at arm's length. The Ninth Circuit withdrew that prior opinion on January 10, 2010, and has now reversed its position, affirming that the arm's-length standard is paramount in cost-sharing, as in other areas of transfer pricing.

Under a qualified cost sharing arrangement, a U.S. company and a related non-U.S. company may split future revenues from intangible property developed under the arrangement as long as they share R&D costs in the same proportion as anticipated future revenues. Whether stock option compensation expenses must be included in the pool of costs that must be shared under a cost sharing arrangement has been highly disputed. Exclusion of such expenses does not change the future sharing of revenues from R&D. Because stock option compensation does not require a cash outlay, allocation of a portion of such expenses to a non-U.S. company is difficult to recoup and the loss of tax deductions for such costs may be particularly expensive. The direct holding of *Xilinx* is that such allocations are not required.

At the crux of the *Xilinx* dispute was a conflict between the general arm's-length standard of the transfer pricing regulations and a specific regulatory requirement that *"all costs"* be shared in cost-sharing arrangements. The Tax Court had previously found that unrelated parties in a cost-sharing agreement would not share employee stock option costs and that requiring Xilinx and its Irish subsidiary to share such costs was a violation of the arm's-length standard.

On appeal, the Ninth Circuit ultimately found that the arm's-length standard could not be reconciled with the requirement that cost-sharing participants share all costs. Although the Ninth Circuit previously held that the specific "all costs" requirement should be interpreted as trumping the arm's-length standard, the Court ultimately rejected this argument, choosing instead to uphold the arm's-length standard.

The *Xilinx* dispute involved tax years 1997, 1998 and 1999, which were not governed by the current cost-sharing regulations. The current cost-sharing regulations provide specifically that stock option compensation costs must be cost shared. The impact of the Ninth Circuit's opinion on the current cost-sharing regulations remains to be seen.

The *Xilinx* opinion also clears the way for the Tax Court to enter its opinion in *Veritas Software Corp.,* another taxpayer-favorable case in which the Tax Court rejected the current IRS theories for valuation of cost-sharing "buy-in" payments (see prior *Alert*. The IRS has shown some uncertainty regarding how to proceed with buy-in examinations in light of *Veritas,* and is expected to appeal *Veritas* to the Ninth Circuit Court of Appeals.

Cost sharing and transfer pricing are important issues to many Cooley clients. The IRS is paying significant attention to cost sharing arrangements and the tax consequences of such arrangements are a Tier I litigation issue for the IRS. The IRS significantly changed the cost sharing regulations at the end of 2008 and has further changed its regulations dealing with a related issue involving contract manufacturing. If you have questions about *Xilinx,* or concerning your cost sharing arrangements, please contact one of our tax attorneys listed above.

# Key Contacts


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