

**Nos. 06-74246, 06-74269**

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**IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT**

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**XILINX, INC. AND CONSOLIDATED SUBSIDIARIES,**

**Petitioner-Appellee**

**v.**

**COMMISSIONER OF INTERNAL REVENUE,**

**Respondent-Appellant**

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**ON APPEAL FROM THE DECISION OF THE  
UNITED STATES TAX COURT**

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**REPLY IN ANSWER TO COMMISSIONER'S RESPONSE AND TO  
SUPPORT PETITION FOR REHEARING OR REHEARING EN BANC OF  
APPELLEE XILINX, INC.**

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In a decision widely regarded as the most significant transfer-pricing decision in decades, the panel opinion in this case reverses the Tax Court and sustains an IRS reallocation of income on the grounds that (i) a regulation dealing with cost-sharing agreements calls for that result and (ii) while that regulation, so construed, conflicts with the core transfer-pricing principle set out elsewhere in the transfer-pricing regulations by imposing a non-arm's-length result, the IRS may depart from the arm's-length standard if it chooses to do so. Xilinx's petition explains that the panel's decision is both wrong and exceptionally important because (i) it is the first decision ever to authorize departure from the arm's-length standard—a result never advocated or endorsed by the IRS; and (ii) any such departure violates both the governing statute and commitments made by the United States to other nations in its network of tax treaties. Submissions by numerous other interested parties, including former senior U.S. and foreign tax officials and dozens of multinational corporations from a broad spectrum of industries, confirm the importance of the case.

In its response, the IRS expressly disavows the panel's reasoning, reasserting its verbal allegiance to the arm's-length standard. It nonetheless defends the panel's result, on the theory that a 1986 amendment to Section 482 authorizes the IRS to *define* a result as "arm's-length" even when actual arm's-length parties would do something different. It argues that, because regulations issued in 2003 adopt such an *Alice in Wonderland* "definition" of "arm's length" as

applied to employee stock options (“ESOs”), the majority’s reasoning here is of no continuing importance, even though the Court’s rationale would permit the government to depart from the arm’s-length standard, as to any transfer-pricing issue, whenever it chooses. And while the IRS acknowledges that all U.S. tax treaties require use of the arm’s-length standard, it dismisses as insignificant the panel’s conclusion that the standard was not applied in this case. These tortured efforts to deny the importance of this case only underscore the need for rehearing.

1. The government expressly agrees with Xilinx that “[l]ongstanding regulations and case law establish that the appropriate means” to implement Section 482 “is an ‘arm’s-length’ approach, pursuant to which the results of the controlled transaction are compared to ‘the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).’” Response:1 (quoting Treas. Reg. § 1.482-1(b)(1)). Indeed, it forthrightly declares that “the majority’s conclusion that the IRS could issue a regulation in derogation of the arm’s-length standard ... does not reflect the Treasury Department’s view.” *Id.* at 18. It thus concedes that the

decision in its favor rests on a fundamental error of law.<sup>1</sup>

The IRS seeks to defend the panel's *result*, but only by adhering stubbornly to its position that the sharing of ESO "costs" is the arm's-length result. *See, e.g., id.* at 12-13. Every judge on the panel joined the Tax Court in rejecting that position. *E.g.,* Opinion:6169 ("If unrelated parties operating at arm's length would not share the ESO cost, requiring controlled parties to share it is simply not an arm's length result."). The majority's decision rests on a conclusion that the result here is "irreconcilable" with the arm's-length standard (*e.g.,* Opinion:6163), but that Section 482 allows the IRS to *depart from* that standard if it chooses (*e.g.,* Opinion:6165 n.5; 6169 n.9). The government's response confirms that the panel has proceeded on a theory that the agency whose regulation it purports to be applying will not defend. *See* Petition:12-13 (citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)). That alone should be a sufficient basis for rehearing.

2. Congress amended Section 482 in 1986, adding a "commensurate with income" ("CWI") standard for "any transfer (or license) of intangible property." *See* Opinion:6160, quoting Section 482. The government argues that this amendment implicitly authorizes the IRS to determine "arm's-length" terms for

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<sup>1</sup> As the petition clearly points out (at 1, 7, 11), the panel's departure from the arm's-length standard conflicts with the Supreme Court's decision in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 404-07 (1972), and with decisions from this and other Circuits, such as *DHL Corp. v. Commissioner*, 285 F.3d 1210, 1217 (9th Cir. 2002).

cost-sharing agreements “without regard to whether unrelated participants in a cost-sharing arrangement would agree to share such costs” (Response:2-3; *see id.* at 1-3, 8-13)—*i.e.*, without regard to whether the terms really are arm’s-length. As the panel’s opinion recognizes, however, transfers and licenses of the sort addressed by the amendment are “types of transactions not at issue in this case.” Opinion:6165 n.5; *see also* Merits Br. for Amici Cisco Systems, Inc. and Altera Corp., Dkt. 39 (filed Jan. 22, 2008). Accordingly, the 1986 amendment provides no authority for the IRS to adopt a “technical connotation” under which a result may be “arm’s-length” even when unrelated parties would not reach it. *See* Response:9, 12-13.<sup>2</sup> If the cost-sharing regulation applicable here requires sharing of ESO deductions under those circumstances (*e.g.*, Opinion:6162-65), then it exceeds the Treasury Department’s statutory authority and is unenforceable to that extent. *See* Petition:11-12.<sup>3</sup>

3. The IRS’s 2003 regulatory amendments do not make the panel’s decision unimportant. If Xilinx is correct about the proper construction of Section 482, the

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<sup>2</sup> The IRS itself stresses “the lack of any indication that Congress intended th[e] CWI] requirement to supplant the arm’s-length standard.” Response:8.

<sup>3</sup> The IRS argues that Xilinx has not urged rehearing based on the panel’s error in construing the cost-sharing regulation to conflict with the arm’s-length standard. Response:5 n.2. To the contrary, as the petition explains (at 12 n.8, 14-15)—and as Judge Noonan argued in dissent (Op:6179-86)—the panel could and should have construed that regulation to harmonize with the IRS’s arm’s-length regulation, with Section 482, and with U.S. treaty commitments. Petition:12 n.8, 14-15. That is an appropriate ground for rehearing.

IRS has no statutory authority to adopt regulations that depart from an ordinary understanding of the arm's-length standard. The 2003 amendments are then unenforceable to the extent they would produce non-arm's-length results. On the other hand, the IRS insists (Response:4, 6, 13-15) that footnote 9 of the panel opinion *already holds* the new regulations "valid[]" (*id.* at 4, 15).<sup>4</sup> In short, as the petition points out (at 10 n.5), the new regulations simply recast the important question presented in this case, making clear the IRS's express intent to re-define the arm's length standard to require a non-arm's length sharing of ESO costs.

Moreover, as amici explain, billions of dollars of tax are at stake under the ESO regulations directly at issue here, both in past years and in the future when employees exercise options granted long ago. *See Br. of Cisco Systems, Inc., et al. Supporting Rehearing at 5, 16-17, Dkt. 70 (filed Sept. 15, 2009).* In addition, this Court's reasoning that the IRS may depart at will from the arm's-length standard will presumably govern in this Circuit, and will be citable as authority in others, in cases involving other transfer-pricing regulations. *Id.* at 5. Adoption of the 2003 regulations therefore certainly does not mean that "the majority's reasoning has no continuing significance in terms of U.S. transfer pricing law." Response:6; *see id.* at 14-15.

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<sup>4</sup> The government makes no attempt to reconcile this position with its later argument (Response:20) that, although "some may argue" the new regulations will "create treaty-based issues going forward," the treaty issues are not ripe for review.

4. Finally, the government's acknowledgment that "all modern U.S. tax treaties embrace the arm's-length standard" (Response:16) confirms the exceptional importance of this case.

The government argues that the Irish treaties have "no direct application" here. *Id.* at 16-17 & n.4. That itself is an important and disputed question.<sup>5</sup> Even if they do not, however, the fact that the entire international tax treaty system requires use of the arm's-length standard by all signatory countries is highly relevant to the proper interpretation of U.S. law. Furthermore, the panel majority's erroneous interpretation of domestic law to permit departures from the international standard is especially significant because of the effect it will have on the proper operation of the treaty system. A transfer pricing standard must be applied reciprocally or it will not work at all.

The IRS's assertion that this case is "not ... an appropriate forum for considering treaty issues" (*id.* at 16; *see id.* at 6, 17-18, 20-21) would leave no forum at all. This case will finally determine Xilinx's rights under domestic law. 26 U.S.C. § 6512. And the mutual agreement procedure provided by the U.S.-Ireland treaty (Response: 17-18) is a consultation among governments. Xilinx cannot use that procedure to seek binding interpretation of the treaty, and has no

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<sup>5</sup> Because all modern tax treaties require use of the arm's-length standard, this Court's opinion addressing the Irish treaties, including their saving provisions (if any), may be applied to virtually every bilateral U.S. tax treaty.



recourse if the United States refuses to respect the plain meaning of the arm's-length standard, which it purports to agree applies in every case under domestic (*id.* at 18-19) as well as treaty law. Indeed, the IRS's own published procedures make perfectly clear that "[o]nce a taxpayer's tax liability ... has been determined by a U.S. court ..., the U.S. competent authority [which conducts mutual-agreement proceedings] similarly will endeavor only to obtain correlative relief from the [other] treaty country and *will not undertake any action that would otherwise reduce the taxpayer's federal tax liability ... as determined by a U.S. court.*" Rev. Proc. 2006-54, § 7.05, 2006-2 C.B. 1035, 1042 (emphasis added).

Precisely because the IRS continues to insist, in opposing rehearing, that the reallocation sustained by the panel decision *is* the arm's-length result, its gesture in the direction of treaty procedures (Response:17-18) is empty, and the prospect of double taxation is not "speculative" (*id.* at 20) at all. The government's response leaves no doubt that in treaty discussions it will substitute its "technical connotation" (*id.* at 9) for the plain meaning of "arm's-length." Yet, no domestic judge in this case has accepted the IRS's position as "arm's-length," and there is no reason to think that any foreign government will either—particularly in light of this Court's unequivocal declaration that it is not (*e.g.*, Opinion:6169), and the IRS's express acknowledgment that arm's-length parties would not in fact share ESO deductions (Opinion:6159-60). Without rehearing, the likelihood of double-taxation is very real.

**CONCLUSION**

The petition for rehearing should be granted.

October 13, 2009

Respectfully submitted,

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I, Kenneth B. Clark, hereby certify that I electronically filed the foregoing REPLY IN ANSWER TO COMMISSIONER'S RESPONSE AND TO SUPPORT PETITION FOR REHEARING OR REHEARING EN BANC OF APPELLEE XILINX, INC. with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage paid, to the following non-CM/ECF participants:

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