Nos. 06-74246, 06-74269

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

XILINX, INC. AND CONSOLIDATED SUBSIDIARIES,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

PETITION FOR REHEARING OR REHEARING EN BANC OF APPELLEE XILINX, INC.

Ronald B. Schrotenboer
Kenneth B.Clark
Tyler A. Baker

FENWICK & WEST LLP
801 California St.
Mountain View, California 94041
(650) 988-8500

Seth P. Waxman
Edward C. DuMont

WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Attorneys for Petitioner-Appellee Xilinx, Inc.
and Consol. Subs.

TABLE OF CONTENTS

GLOSSARY OF TERMS

Parties, Opinions, Briefs and Excerpts of Record

Xilinx – refers to Petitioner-Appellee, Xilinx, Inc.

Op – refers to this Court’s May 27, 2009 opinion, a copy of which is attached as Addendum A; references to the opinion are to Op followed by the page number(s) (“Op:__”).

TaxCtOp – refers to the Tax Court's August 30, 2005 opinion (*Xilinx Inc. v. Comm'r*, 125 T.C. 37 (2005)), a copy of which is attached as Addendum B.

IRSOpBr – refers to Commissioner’s Opening Brief.

IRS Pre-Trial Brief – refers to Memorandum Brief in Support of Respondent's Notice of Objection to Petitioner's Supplement to Partial Summary Judgment Motion with Respect to the Stock Option Issue, as corrected, filed with U.S. Tax Court on September 16, 2002, listed as item 0053 on Tax Court docket no. 4142-01, at ER:59.

ER – refers to Appellant’s excerpts of record.

SER – refers to Appellee’s supplemental excerpts of record.

Regulations and Related Items

1993 Temporary Regulations – refers to T.D. 8470, 1993-1 C.B. 90.

1994 Preamble – refers to the introductory material to the 1994 section 482 regulations issued by T.D. 8552, 1994-2 C.B. 93.

IRS Reports and Related Items

White Paper – refers to Notice 88-123, A Study of Intercompany Pricing Under Section 482 of the Code, 1988-2 C.B. 458 (1988); a copy is at SER:65-142.

1992 IRS Report – refers to the 1992 IRS Report on the Application and Administration of Section 482 (Apr. 10, 1992), 92 TNT 77-19 (LEXIS); excerpts are at SER:53-64.

1999 IRS Report – refers to the 1999 IRS Report on the Application and Administration of Section 482 (Apr. 21, 1999), 1999 TNT 108-10 (LEXIS).

2003 Treasury Report – refers to Gordon C. Milbourn III, U.S. Dept. of the Treasury Assistant Inspector General for Audit (Small Business and Corporate Programs) Memorandum and Final Audit Report – Current Trends in the Administration of International Transfer Pricing by the Internal Revenue Service (Audit #200230038), 2003-30-174 (September 15, 2003), 2003 TNT 185-39.

2007 Treasury Report – refers to the Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (November 28, 2007), 2007 TNT 230-17.

Congressional Reports and Treaty Documents

1949 U.S.-Ireland Tax Treaty or 1949 Treaty – refers to the Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, (September 13, 1949, 81st Cong., 2d sess.).

1996 U.S. Model Technical Explanation -- this refers to the Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996, *reprinted in* 1 Tax Treaties (CCH) ¶ 214A (attached as exhibit to First Stipulation ¶ 225, 62-P, CR:132, ER:65) - citations are to CCH page numbers.

1997 Ireland Treaty Explanation or Treaty Explanation – refers to Department of the Treasury Technical Explanation of the 1997 U.S.-Ireland Tax Treaty, defined below, at 2 Tax Treaties (CCH) ¶ 4435 - citations are to CCH page numbers.

1997 U.S.-Ireland Treaty or 1997 Treaty – refers to the Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, July 28, 1997, U.S. -Ireland, S. Treaty Doc. No. 105-31, 1997 U.S.T. LEXIS 98, 2 Tax Treaties (CCH) ¶ 4401.

1997 Joint Committee Treaty Explanation – refers to the Staff of the Joint Comm. on Taxation, 105th Cong., Explanation of Proposed Income Tax

Treaty and Proposed Protocol Between the United States and Ireland, JCS-17-97 (Comm. Print 1997).

2004 Joint Committee Report – refers to the Staff of the Joint Comm. on Taxation, 108th Cong., "Description of the 'Highway Reauthorization and Excise Tax Simplification Act of 2004,'" JCX-5-04 (Comm. Print 2004).

OECD Commentaries – refers to the OECD Commentaries to the 1992 OECD Model Tax Convention on Income and Capital as updated in 1995, Rhoades and Langer, 6 U.S. International Taxation and Tax Treaties MOD-2.

TABLE OF AUTHORITIES

CASES

CODE AND REGULATIONS

TREATY DOCUMENTS

OTHER AUTHORITIES

RULE 35 STATEMENT

This case involves the principle at the heart of a major area of federal and international tax law—"transfer pricing" in related-party transactions. The panel's divided decision presents an exceptionally important question: Whether this Court may apply a U.S. transfer-pricing regulation in a way that is "irreconcilable" (Op:6163) with the "arm's-length" standard, when that standard has always been the statutory standard for taxation of such transactions under U.S. law; is the international norm, championed by the United States and embodied in numerous treaties; and is the only basis on which the government has ever defended the result it sought in this case.

Eighty years of law and practice have established that the touchstone for all transfer-pricing analysis is the "arm's-length" standard—*i.e.*, the result that would have been reached by unrelated parties who engaged in the same transaction. *E.g.*, *Comm'r v. First Sec. Bank of Utah*, 405 U.S. 394, 400, 407 (1972); *Advance Cloak Co. v. Comm'r*, B.T.A.M. (P-H) ¶ 33,078, 1933 WL 4800, at 4 (1933). The panel majority, reversing the Tax Court, holds that the IRS is free to depart from that standard, and upholds an IRS reallocation of income that every judge reviewing this case has agreed is *not* an arm's-length result.[1] That rationale is one never advocated or defended by the IRS.

[1] The panel and Tax Court decisions are attached as Addenda A and B.

The government has always urged the centrality of the arm's-length standard under domestic law—including consistently in this case. And the United States has labored to make arm's-length the international standard, embodied in tax treaties. The standard has guided business planning and statutory, regulatory, and treaty interpretations for related-party transactions involving trillions of dollars every year. The specific question in this case, involving employee stock options, affects many corporations and *billions* in potential tax liability; but the implications of U.S. departure from the arm's-length standard are even broader. Indeed, former senior tax officials from major U.S. treaty partners have written to the Clerk expressing substantial concern and supporting further review. *See* Addendum E.

The Treasury has said that transfer-pricing issues are among the most important facing tax authorities. 2003 Treasury Report:2. It expressly told Congress that the government designated this specific case for litigation because it "involve[s] issues of broad significance." 2007 Treasury Report:37. In its opening brief, the government advised the Court that "[t]he potential impact of the Tax Court's decision extends well beyond this case." IRSOpBr:45 n.17. And after the panel issued its decision, a leading practitioner told the *Wall Street Journal* that it was "the most important transfer-pricing decision in this country in 20 years."[2] Xilinx believes the government will be hard-pressed to disagree. This case merits rehearing or rehearing en banc.

BACKGROUND

1. The basic issue in transfer-pricing is straightforward. Unrelated parties negotiate transactions at arm's-length. Related parties, however, can arrange transactions on terms that unrelated parties would not accept but that generate tax benefits for the overall enterprise. If a distributor in high-tax country X pays above-market prices to a related manufacturer in low-tax country Y, the group's economic profit remains the same, but taxable income is concentrated in the lower-tax jurisdiction.

To address this issue, the Internal Revenue Code has for more than 80 years authorized the Treasury to reallocate income or deductions among commonly-controlled entities if doing so "is necessary in order to prevent evasion of taxes or clearly to reflect … income." I.R.C. Section 482 (quoted at Op:6160). The operative principle has always been clear: "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1) (quoted at Op:6161); *see* Treas.

[2] Drucker, *Chip Maker Xilinx Loses Tax Ruling*, Wall St. J., May, 29, 2009, at B4.

Regs. 86, Article 45-1(b) (1935) (same). That is, Section 482 is satisfied if "the results of [a] transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)." Treas. Reg. § 1.482-1(b)(1) (quoted at Op:6161). The Treasury has never advocated any different rationale for reallocation under Section 482.

2. Xilinx sells integrated circuits and related software. Its subsidiary Xilinx Ireland ("XI") conducts similar business in Europe. In 1995, Xilinx and XI entered into an arrangement, of a type used by many companies, to share the costs and benefits of developing new technology. In general, they agreed to share all development-related costs in proportion to the benefits each expected from the joint effort. Op:6156-57.

In determining the pool of costs to be shared, Xilinx included no amount for employee stock options (ESOs) received or exercised by Xilinx employees. ESOs were issued in various ways (Op:6157), none of which involved any cash cost to Xilinx.

After examining Xilinx's returns for 1997-1999, the IRS asserted that Xilinx should have split with XI certain U.S. tax deductions that Xilinx received when, during those years, employees either exercised or made "disqualifying dispositions" of certain options granted in earlier years.

Op:6158; TaxCtOp:47.[3] The IRS argued that these amounts were "costs" under a regulation that requires parties to certain cost-sharing agreements to share "all of the costs incurred" in research efforts. Treas. Reg. § 1.482-7(d)(1) (quoted at Op:6162). Significantly, the IRS never questioned whether, as a legal matter, the issue was governed by the arm's-length standard. It "simply contend[ed] that the 'application of the express terms of [Section 1.482-7] itself produces an arm's-length result.'" TaxCtOp:54.

The Tax Court rejected that contention, holding that the arm's-length standard applied and that whether or not it was met was a question of fact. TaxCtOp:55-58. It found that unrelated parties would not treat ESO deductions as sharable "costs." TaxCtOp:58-61. The court explained that the likelihood, timing, and amount of any employee income inclusion and matching employer deduction for ESOs are unpredictable and widely variable. TaxCtOp:58-60. "Unrelated parties would not share the spread

[3] For tax purposes, employees are sometimes (not always) treated as receiving income if and when an option is exercised, with the amount determined by the "spread" between the exercise price (set when the option was issued) and the market price on the exercise date. *See* Op:6157; TaxCtOp:41 & n.5. If and when amounts are included in an employee's income, Code Section 83(h) allows the employer a matching deduction. Neither the inclusion nor the deduction corresponds to any measure of value at the date of grant or to any amount required to be included as an expense in the employer's U.S. financial statements—issues that have themselves been debated for many years. *See, e.g.*, TaxCtOp:44-46; Cope & Zollo, *Xilinx: A Case Study in Judicial Activism*, 38 Tax Mgm't Int'l J. No. 8, n.12 & accompanying text (2009).

because it is difficult to estimate, unpredictable, and potentially large in amount." TaxCtOp:59. The government accepted that factual finding on appeal. Op:6159.

3. On review, the panel unanimously agreed that including in a shared-cost pool the employer deductions that may arise from employees' exercise or disposition of ESOs is "simply not an arm's length result." Op:6169; Op:6180 (Noonan, J., dissenting). A majority, however, held that Section 1.482-7(d)(1)'s phrase "all of the costs incurred" nonetheless requires sharing of those deductions. Op:6168 n.8, 6172-77. Acknowledging that this result is "irreconcilable" (Op:6162-63) with the requirement that the arm's-length standard be applied "in every case" (Section 1.482-1(b)(1)), the majority relied on the canon that specific rules often control general ones to hold that ESO deductions must be shared. Op:6165-66.

The majority recognized that the U.S.-Ireland tax treaty—applicable here because XI is an Irish corporation—embodies the arm's-length standard for transfer-pricing allocations. Op:6169-71. It saw no problem, however, in construing U.S. law in a manner "at odds with the treaty's arm's length standard," because in its view a "saving clause" in the current treaty "allows a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty." Op:6171.

Thus, the majority's opinion: (i) accepts the Tax Court's finding that unrelated parties would have treated ESO deductions just as Xilinx and XI did (Op:6159, 6168-69, 6176); (ii) flatly rejects the IRS's argument that reallocating ESO deductions is consistent with the arm's-length standard (Op:6163, 6165, 6168, 6171); and yet (iii) sustains the reallocation as consistent with Section 482, even in light of U.S. treaty commitments. That unprecedented departure from the arm's-length standard warrants further review.

I. THE MAJORITY'S DECISION IMPROPERLY ABANDONS THE ARM'S-LENGTH STANDARD AS THE STATUTORY TOUCHSTONE FOR U.S. TRANSFER PRICING LAW

1. In 1933, the Board of Tax Appeals observed that the purpose of what is now Section 482 was "to place transactions between related trades or businesses owned or controlled by the same interests upon the same basis as if such businesses were dealing at arm's length with each other." *Advance Cloak*, 1933 WL 4800, at 4. The Supreme Court, this Court, and others have repeatedly reaffirmed this principle. *See, e.g.*, *First Sec. Bank*, 405 U.S. at 400, 407 ("As stated in the Treasury Regulations, the 'purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer....'"); *DHL Corp. v. Comm'r*, 285 F.3d 1210, 1217 (9th Cir. 2002); *Kenco Restaurants, Inc. v. Comm'r*, 206 F.3d 588, 595 (6th Cir. 2000); *Barford v. Comm'r*, 194 F.3d 782, 787 (7th Cir. 1999).

For decades, Treasury has consistently embraced the arm's-length standard. In 1988, for example, after Congress added a second sentence to Section 482, a comprehensive Treasury "White Paper" concluded that the amendment clarified "the legal standard for determining arm's length pricing" and that arm's-length treatment is the "accepted international norm" for transfer-pricing adjustments. SER:65. Similarly, in 1992 the IRS reported to Congress that "[t]he standard … the IRS applies in a transfer pricing case is the internationally accepted 'arm's length' standard." 1992 IRS Report, SER:57.

In 1993, Treasury "reorganized" the regulatory scope-and-purpose provisions quoted by the Supreme Court in *First Security Bank* "to make clear that the arm's length standard is the guiding principle for all allocations under section 482." 1993 Temporary Regulations:92 (preamble). Finalizing those regulations in 1994, it reiterated that "Section 482 is concerned only with whether the taxpayer reports its true taxable income" in accordance with the arm's-length standard. 1994 Preamble:98. The final regulations are unequivocal:

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.

> …
>
> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.

Section 1.482-1(a)(1), (b)(1) (quoted at Op:6160-61).

Treasury has never varied from its position that the arm's-length standard applies to all transfer-pricing, including cost-sharing. It has recommended ratification of numerous tax treaties, including the 1997 U.S.-Ireland Treaty, that expressly adopt the standard. In explaining the 1997 Treaty for purposes of Senate ratification, it observed that a cost-sharing transaction, like any other, "must" be examined to "see whether or not it meets the arm's-length standard." Treaty Explanation, SER:237. Similarly, the IRS reported to Congress in 1999 that "[u]nder current Treasury Regulations"—including the 1995 cost-sharing regulation applicable here—"the IRS is willing to consider many different approaches to … transfer pricing methodology *or cost sharing* practices, *provided these approaches satisfy the arm's length principles*." 1999 IRS Report:36 (emphasis added). Many congressional reports likewise confirm Congress's understanding that the arm's-length standard governs under Section 482.[4]

2. The government has never argued that Section 482 permits any departure from the arm's-length standard. Both in this Court and in 2003 amendments to its cost-sharing regulation, the IRS has asserted only that including ESO deductions in sharable "costs" *is* "an arm's length result." Op:6168-69 & n.9. Every judge in this case has flatly rejected that contention. Op:6168-69; Op:6180 (Noonan, J.); TxCtOp:54-58. The IRS may not simply declare that a reallocation satisfies the arm's-length standard when it does not.[5]

The panel majority would nonetheless hold that the "plain language" of the cost-sharing regulation requires including ESO deductions (Op:6168 n.8), and that Section 482 allows that non-arm's-length result. Op:6165 n.5, 6167 & n.7. Pointing to statutory and regulatory language about "prevent[ing] evasion" and "clearly … reflect[ing] … income," the majority treats Section 482 as a general anti-abuse provision; describes the arm's-

[4] *E.g.*, 2004 Joint Committee Report:138 ("More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an 'arm's length' standard....").

[5] Because the 2003 amendments to the cost-sharing regulation merely reassert, in regulatory form, the rejected position that ESO adjustments produce an arm's-length result, they do not change the prospective importance of the issues presented here.

length standard as merely a "regulatory gloss"; and denies that the regulations' "singular purpose is to ensure tax parity" between controlled and arm's-length taxpayers. Op:6165 & n.5, 6167 & n.7, 6169 & n.9. That is fundamental error.

Section 482 is not a general anti-evasion provision. It authorizes reallocation of income or deductions only when a distortion of income arises *from common control*. *See First Sec. Bank*, 405 U.S. at 404-05 ("It is only where this power [to shift income among subsidiaries] exists, and has been exercised in such a way that the 'true taxable income' of a subsidiary has been understated, that the Commissioner is authorized to reallocate under § 482.").[6] If a transaction meets the arm's-length standard, then by definition common control—the statutory premise for IRS action—has not distorted either party's income or led to any evasion. Accordingly, under this statute, achieving "tax parity with an uncontrolled taxpayer" (*id*. at 407)

---

[6] *See also, e.g., Hosp. Corp. of Am. v. Comm'r*, 81 T.C. 520, 593 (1983) ("[I]f the dealings between controlled organizations are fair and equivalent in result to arm's-length bargaining, no allocation is authorized."); *Grenada Indus. v. Comm'r*, 17 T.C. 231, 254 (1951), *aff'd* 202 F.2d 873 (5th Cir. 1953) ("The purpose of [predecessor to section 482] is not to punish the mere existence of common control or ownership, but to assist in preventing distortion of income and evasion of taxes through the exercise of that control or ownership."); Schrotenboer, *The Arm's Length Standard and the Limits of IRS Authority*, 17 Transfer Pricing Rep. 430 (2008).

is indeed the "singular purpose."[7] Op:6167 n.7; *see* Op:6180 (Noonan, J., dissenting). If, as the majority concludes, the "plain language" of Section 1.482-7(d)(1) sometimes conflicts with that limited statutory authority for reallocation, then the regulation is unenforceable to the extent it exceeds the statutory authorization. *Cf., e.g., Cuomo v. Clearing House Ass'n, L.L.C.*, 129 S. Ct. 2710, 2717 (2009) (enforcing regulation only to extent authorized by statute).[8]

The panel majority sustains the IRS's reallocation on a rationale *never advanced or defended by the government itself*, and completely at odds with decades of uniform administrative and judicial construction of Section 482. *Cf. SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947) ("[A] reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely

[7] *See* Kohl, *Clear Reflections on How the Ninth Circuit Got Xilinx Wrong*, 124 Tax Notes 259 (2009).

[8] The panel could have avoided conflict between the cost-sharing regulation and Section 482 by construing the regulation to require sharing of all costs that would be shared by arm's-length parties. As the panel observes (Op:6174 n.13), what "costs" must be shared "turns on whether an item is an 'operating expense'" under a cross-referenced provision. That provision (Section 1.482-5(d)(3)) describes the "comparable profits" method, which—like all Section 482 methods—is used to "*determine the arm's length result.*" Section 1.482-1(b)(2) (emphasis added). Stipulations establish that IRS practice has recognized ESOs *not* to be "operating expenses" under the cross-referenced language. SER:5-11, 48-50, 144-145, 148-149.

by the grounds invoked by the agency.”). The specific/general canon of construction cited by the majority—which, like any canon, is persuasive only “where there is no clear indication otherwise” (Op:6165; *see also* Op:6180 (Noonan, J.))—neither requires nor justifies that result. On the contrary, *every* indication is that Treasury has always correctly understood Section 482 to require use of the arm’s-length standard, and always intended its regulations to require arm’s-length results. The majority’s decision to sustain the IRS’s reallocation after flatly rejecting its arm’s-length rationale effectively unmoors U.S. transfer-pricing law from what for decades has been its central statutory and theoretical principle. That fundamental and far-reaching error warrants en banc review.

II. THE MAJORITY’S DECISION CANNOT BE RECONCILED WITH THE ARM’S-LENGTH PROVISIONS OF U.S. TAX TREATIES

The panel decision is also exceptionally significant because it puts U.S. domestic law at odds with the arm’s-length standard embodied in U.S. treaties and long urged by the United States as the proper international norm. The United States has ratified more than 50 bilateral tax treaties, including the two directly relevant here, containing arm’s-length transfer-pricing provisions. Yet, the panel majority for the first time upholds a non-arm’s-length reallocation under U.S. law. That approach cannot be squared with the United States’ international positions and commitments. *Compare Nat’l*

Westminster Bank, PLC v. United States, 512 F.3d 1347 (Fed. Cir. 2008) (arm's-length provision of tax treaty overrides conflicting regulatory formula).

As the majority recognizes, the 1997 U.S.-Ireland Treaty requires use of the arm's-length standard, which Treasury's authoritative explanation confirms is "identical to the arm's length standard in § 1.482-1(b)(1)." Op:6171; *see* Op:6169-70. Although the majority does not mention it, the 1949 U.S.-Ireland Treaty—governing the first two years at issue here—includes a comparable arm's-length provision.[9] Because the IRS's reallocation of ESO deductions to XI "is simply not an arm's length result" (Op:6169), it is as "irreconcilable" with these treaty provisions as it is with Treasury's arm's-length regulations. *See* Op:6165. As Judge Noonan recognized (Op:6185), the majority should have avoided a construction of the cost-sharing regulation that creates this double conflict. *See, e.g.*, *Ventress v. Japan Airlines*, 486 F.3d 1111, 1115 (9th Cir. 2007) ("Federal law must … be strictly construed to avoid conflict with treaty obligations."); *Freedom to Travel Campaign v. Newcomb*, 82 F.3d 1431, 1441-42 (9th Cir. 1996) (regulation and treaty should be construed consistently, because "acts

[9] Relevant treaty provisions are reproduced in Addendum C.

of Congress should not be construed to conflict with international treaty obligations").

Having incorrectly construed U.S. law to reach a non-arm's-length result, the majority invokes the "saving clause" of the 1997 U.S.-Ireland Treaty, arguing that "the treaty expressly allows a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty." Op:6171. That position—first suggested by the IRS in simultaneous supplemental briefing in this Court—cannot justify the majority's holding.[10]

First, whatever the scope of the saving clause, the treaties are an important guide for construing domestic law. *See* Op:6185 (Noonan, J., dissenting). Treasury's technical explanation of the 1997 Treaty confirms that a cost-sharing arrangement "must be examined," "[a]s with any other kind of transaction," "to see whether or not it met the arm's-length standard." SER:236-237 (extensively quoted at Op:6183-84). Because the treaty's arm's-length provision "incorporates in the Convention the arm's

[10] Previously, the IRS accepted the treaties as "legally binding interpretations concerning the applicability of the arm's length standard to cost sharing arrangements," arguing only that "[b]ecause the U.S.-Ireland (and other) tax treaties incorporate the same arm's length standard as used under section 482 and its regulations, adjustments sustained under the U.S. standard should be acceptable to treaty partners." IRS Pre-Trial Brief:79 & n.38.

length principle reflected in … U.S. domestic transfer pricing" law (*id*.), this explanation necessarily applies to Section 482 and the 1995 cost-sharing regulation. Both the 1997 Treaty itself and Treasury's contemporaneous, authoritative interpretation confirm that U.S. domestic law requires arm's-length treatment.

Second, the majority ignores the 1949 Treaty, which governs two of the three years at issue here and does not contain a comparable saving clause.

Third, the majority did not consider the entire text of the 1997 Treaty. Article 1(4) states a general rule that each nation may tax its residents (including corporations) "as if the Convention had not come into effect." Article 1(5) lists specific exceptions. These include Articles 9(2) and 26, which together establish that, when one nation reallocates income to a taxpayer based on a related-party transaction, the other related party may seek offsetting relief—which the other nation has an obligation to grant, *if* it agrees that the reallocation produces an arm's-length result. In case of doubt, the "competent authorities" of the two nations "shall endeavour" to agree on, among other things, "the same allocation of income, deductions, credits, or allowances," "with a view to the avoidance of taxation which is not in accordance with the Convention." Article 26(3). The specific carve-out for these articles makes clear that the saving clause does not waive either nation's direct obligation to the other to apply the arm's-length standard in reallocating income between related parties covered by the treaty.[11]

Fourth, treaties, as agreements between countries, must be construed to effectuate the intent, expectations, and purposes of the parties. *E.g.*, *United States v. Stuart*, 489 U.S. 353, 365-66 (1989); *Gonzalez v. Gutierrez*, 311 F.3d 942, 948 (9th Cir. 2002). The majority's reliance on the saving clause fails that test.

The United States has ratified dozens of treaties with arm's-length provisions, without the slightest indication that saving clauses would permit either party's domestic law to depart from a standard that must be uniformly and reciprocally applied if the treaties are to achieve their primary goal of avoiding double taxation. On the contrary, the Joint Committee on Taxation's pre-ratification report on the 1997 U.S.-Ireland Treaty states, for example, that the treaty's transfer-pricing provision "does not limit the rights of the respective countries to apply their internal intercompany pricing

[11] Article 1(5) does not carve out of the saving clause Article 9(1), which states that each nation may reallocate income to its taxpayers to achieve arm's-length results. That makes sense. Article 9(1) recognizes each *nation's* right to reallocate taxable income to its own taxpayers on an arm's-length basis. There is no conflict between that provision and each nation's right to tax its own residents, and thus no need to carve it out of the saving clause. What Article 1(5) preserves as binding on both governments are provisions relating to "benefits conferred" on taxpayers—here, having transfer-pricing allocations by both nations made on a uniform, arm's-length basis.

rules … *provided that such rules are in accord with the arm's-length principle*." 1997 Joint Committee Treaty Explanation Art. 9:19-20 (emphasis added). *See also, e.g.*, Treaty Explanation Art. 9(1), at CCH 32,017-24 (domestic adjustments permitted "as long as they accord" with arm's-length standard); 1996 U.S. Model Technical Explanation Art. 9(1), at CCH 10,633-4; OECD Commentaries:146 ("No re-writing of the accounts of associated enterprises is authorised if the transactions … have taken place on normal open market commercial terms (on an arm's length basis).").

The majority's approach would effectively nullify the standard "associated enterprises"/"correlative adjustment" and "competent authority" provisions discussed above (Articles 9(2) and 26). Ireland would have no obligation to accord XI an "appropriate adjustment" under Article 9(2), offsetting the IRS's reallocation of income to Xilinx, because, as every judge to consider this case has agreed, the IRS's reallocation is not arm's-length. The United States, on the other hand, would presumably decline to reverse a reallocation sustained by a U.S. court. The result would be complete frustration of the treaty's arms-length provisions and competent-authority mechanism.

This cannot possibly be how the saving clause, or the rest of the treaty, was intended to operate—or how the treaty partners understood that the United States would apply domestic law. *See, e.g.*, 1992 IRS Report:8 (acknowledging a treaty "obligation to apply the arm's length principle to residents of the treaty country"—here, XI); *cf. South Dakota v. Yankton Sioux Tribe*, 522 U.S. 329, 346, 348 (1998) (declining to "read the saving clause [of a treaty] in a manner that eviscerates the agreement in which it appears," and holding that specific substantive language "'governs the general' terms of the saving clause"). Indeed, after the panel decision, Ireland asked U.S. authorities for consultation if the decision becomes final, "because it [is] not clear how, consistent with the decision, double taxation could be avoided." *See* Addendum D. And former senior tax officials of major U.S. trading partners have expressed concern in a letter to the Clerk. *See* Addendum E.

In short, as Treasury has stressed, "overwhelming evidence" (SER:82) confirms that the arm's-length standard is the international transfer-pricing norm, "incorporated into all U.S. income tax treaties." SER:57. Yet the panel majority holds, *for the first time ever*, that U.S. law applies a different standard. That holding will create uncertainty and undercut the uniform international standard that Treasury has labored to establish. It is exceptionally important, and warrants further review.

CONCLUSION

The Court should grant rehearing or rehearing en banc.

August 12, 2009

Respectfully submitted,

/s/ Seth P. Waxman
SETH P. WAXMAN
EDWARD C. DUMONT

/s/ Kenneth B. Clark
Kenneth B.Clark

Ronald B. Schrotenboer
Kenneth B.Clark
Tyler A. Baker
FENWICK & WEST LLP
801 California St.
Mountain View, California 94041
(650) 988-8500

Seth P. Waxman
Edward C. DuMont
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Attorneys for Petitioner Xilinx, Inc.

CERTIFICATE OF COMPLIANCE

I, Kenneth B. Clark, attorney for Petitioner-Appellee Xilinx, Inc. and Consolidated Subsidiaries, hereby certify that:

Pursuant to Ninth Circuit Rules 35-4 and 40-1, the attached petition for rehearing en banc is proportionately spaced, has a typeface of 14 points in Times New Roman font and contains 4,179 words.

/s/ Kenneth B. Clark
Kenneth B. Clark

Dated: August 12, 2009

ADDENDUM A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

XILINX, INC., AND CONSOLIDATED SUBSIDIARIES, *Petitioner-Appellee,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellant.*	No. 06-74246 Tax Ct. No. 702-03
XILINX, INC., AND CONSOLIDATED SUBSIDIARIES, *Petitioner-Appellee,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellant.*	No. 06-74269 Tax Ct. No. 4142-01 OPINION

Appeal from a Decision
of the United States Tax Court
Maurice B. Foley, Tax Court Judge, Presiding

Argued and Submitted
March 12, 2008—San Francisco, California

Filed May 27, 2009

Before: Stephen Reinhardt, John T. Noonan, Jr. and
Raymond C. Fisher, Circuit Judges.

Opinion by Judge Fisher;
Dissent by Judge Noonan

COUNSEL

Ronald B. Schrotenboer, Kenneth B. Clark (argued) and Tyler A. Baker, Fenwick & West LLP, Mountain View, California, for the petitioner-appellee.

Gilbert S. Rothenberg, Richard Farber and Arthur T. Catterall (argued), Tax Division, Department of Justice, Washington, D.C., for the respondent-appellant.

Alice E. Loughran, Steptoe & Johnson LLP, Washington, D.C., for amici curiae Cisco Systems, Inc., and Altera Corporation.

A. Duane Webber, Baker & McKenzie LLP, Washington, D.C., for amici curiae Software Finance and Tax Executives Council and AeA.

OPINION

FISHER, Circuit Judge:

On this appeal from the tax court, we must decide whether, under the tax regulations in effect during tax years 1997, 1998 and 1999, related companies engaged in a joint venture to develop intangible property must include the value of certain stock option compensation one participant gives to its employees in the pool of costs to be shared under a cost sharing agreement, even when companies operating at arm's length would not do so. The tax court found related companies are not required to share such costs and ruled that the

Commissioner of Internal Revenue's attempt to allocate such costs was arbitrary and capricious. We reverse and hold: (1) related companies in a cost sharing agreement to develop intangibles must share *all* costs related to the joint venture, even if unrelated companies would not do so; (2) stock options for which companies claim tax deductions are a cost under former 26 C.F.R. § 1.482-7(d)(1); and (3) such costs are "related to" the intangible product development, as part of the compensation package offered to employees involved in activities under the joint venture.[1]

I. BACKGROUND

Xilinx, Inc. ("Xilinx") researches, develops, manufactures, markets and sells integrated circuit devices and related development software systems. Xilinx wanted to expand its position in the European market and established Xilinx Ireland ("XI") in 1994 as an unlimited liability company under the laws of Ireland. XI sold programmable logic devices and conducted research and development ("R&D"). Two wholly owned Irish subsidiaries of Xilinx owned XI during the tax years of 1997, 1998 and 1999, the only years at issue in this appeal.

In 1995, Xilinx and XI entered into a Cost and Risk Sharing Agreement ("the Agreement"), which provided that all right, title and interest in new technology developed by either Xilinx or XI would be jointly owned. Under the Agreement, each party was required to pay a percentage of the total R&D costs in proportion to the anticipated benefits to each from the new technology that was expected to be created. Specifically, the Agreement required the parties to share: (1) direct costs, defined as costs directly related to the R&D of new technol-

[1]For the purposes of this opinion, all citations and references to regulations are to the regulations in effect during tax years 1997, 1998 and 1999. The relevant regulations have been amended repeatedly since then, most recently in 2009, *see, e.g.*, T.D. 9441, 2009-7 I.R.B. 460.

ogy, including, but not limited to, salaries, bonuses and other payroll costs and benefits; (2) indirect costs, defined as costs incurred by departments not involved in R&D that generally benefit R&D, including, but not limited to, administrative, legal, accounting and insurance costs; and (3) costs incurred to acquire products or intellectual property rights necessary to conduct R&D. The Agreement did not specifically address whether employee stock options (ESOs) were a cost to be shared.

Xilinx offered ESOs to its employees under two plans. Under one plan, employees were granted options as part of the employee hiring and retention program. The options were of two varieties: incentive stock options (ISOs) and nonstatutory stock options (NSOs). Employees could exercise these options two ways: (1) by purchasing the stock at the market price on the day the option was issued ("exercise price") regardless of its then-current market price or (2) by simultaneously exercising the option at the exercise price and selling it at its then-current price, pocketing the difference. Under the other plan, employees could acquire employee stock purchase plan shares (ESPPs) by contributing to an account through payroll deductions and purchasing stock at 85 percent of either its exercise price or its market price on the purchase date. Employees must always pay taxes on NSOs, *see* 26 U.S.C. § 83, but have to pay taxes on ISOs and ESPPs only if they sell acquired stock shares before a specified waiting period has expired ("a disqualifying disposition"), *see* 26 U.S.C. § 421(b). In determining the R&D costs to be shared under the Agreement for tax years 1997, 1998 and 1999, Xilinx did not include any amount related to ESOs.

In tax years 1997, 1998 and 1999, Xilinx deducted as business expenses under 26 U.S.C. §§ 83 and 162 approximately $41,000,000, $40,000,000 and $96,000,000, respectively, based on its employees' exercises of NSOs or disqualifying dispositions of ISOs and ESPPs.[2] It also claimed an R&D

[2]Under 26 U.S.C. § 162(a)(1), employers may deduct from their taxable income "all the ordinary and necessary expenses paid or incurred during

credit under 26 U.S.C. § 41 for wages related to R&D activity, of which approximately $34,000,000, $23,000,000 and $27,000,000 in the respective tax years were attributable to exercised NSOs or disqualifying dispositions of ISOs and ESPPs.[3] Furthermore, in 1996 Xilinx and XI entered into two agreements that allowed XI employees to acquire options for Xilinx stock. Both agreements provided XI would pay Xilinx for the "cost" of the XI employees' exercise of the stock options, which was to equal the stock's market price on the exercise date minus the exercise price. In the 1997, 1998 and 1999 tax years, XI paid Xilinx $402,978, $243,094 and $808,059, respectively, under these agreements.

The Commissioner of Internal Revenue ("Commissioner") issued notices of deficiency against Xilinx for tax years 1997, 1998 and 1999, contending ESOs issued to its employees involved in or supporting R&D activities were costs that should have been shared between Xilinx and XI under the Agreement. Specifically, the Commissioner concluded the amount Xilinx deducted under 26 U.S.C. § 83(h) for its employees' exercises of NSOs or disqualifying dispositions of ISOs and ESPPs should have been shared. By sharing those costs with XI, Xilinx's deduction would be reduced, thereby increasing its taxable income. The Commissioner's determination resulted in substantial tax deficiencies and accuracy-related penalties under 26 U.S.C. § 6662(a).

Xilinx timely filed suit in the tax court. The tax court denied cross motions for summary judgment. After a bench

---

the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered." Under 26 U.S.C. § 83(h), employers may deduct under § 162 the value of any property transferred to an employee in connection with the performance of employment.

[3]Under 26 U.S.C. § 41(b)(2)(A), companies can claim a tax credit for "wages paid or incurred to an employee for qualified [research] services performed by such employee."

trial, the tax court found that two unrelated parties in a cost sharing agreement would not share any costs related to ESOs. After assuming ESOs were costs for purposes of 26 C.F.R. § 1.482-7(d)(1), the tax court then found 26 C.F.R. § 1.482-1(b)(1) — which requires cost sharing agreements between related parties to reflect how two unrelated parties operating at arm's length would behave — dispositive and concluded the Commissioner's allocation was arbitrary and capricious because it included the ESOs in the pool of costs to be shared under the Agreement, even though two unrelated companies dealing with each other at arm's length would not share those costs.

The Commissioner timely appealed. On appeal, the parties focused primarily on whether the requirement in 26 C.F.R. § 1.482-7(d)(1) that "all costs" be shared between related parties in a cost sharing agreement or the requirement in 26 C.F.R. § 1.482-1(b)(1) that all transactions between related parties reflect what two parties operating at arm's length would do controlled. After oral argument, we requested supplemental briefing on whether ESOs were "costs" and whether they were "related to" the intangible product development for purposes of 26 C.F.R. § 1.482-7(d)(1), and whether a literal application of 26 C.F.R. § 1.482-7(d)(1) would conflict with a tax treaty between the United States and Ireland that was in effect during the 1998 and 1999 tax years.

II. STANDARD OF REVIEW

"Decisions of the tax court are reviewed on the same basis as decisions from civil bench trials in the district court." *DHL Corp. v. Comm'r*, 285 F.3d 1210, 1216 (9th Cir. 2002). "Thus, we review the tax court's conclusions of law de novo and its factual findings for clear error." *Id.*

III. DISCUSSION

The Commissioner does not dispute the tax court's factual finding that unrelated parties would not share ESOs as a cost.

Instead, the Commissioner maintains ESOs are a cost that must be shared under § 1.482-7(d)(1), even if unrelated parties would not share them.

A. 26 C.F.R. §§ 1.482-1(b)(1) and 1.482-7(d)(1) Are Irreconcilable, so § 1.482-7(d)(1), the More Specific of the Two, Controls.

Congress has authorized the Secretary of the Treasury to allocate income and deductions among related business entities to prevent tax avoidance.

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

26 U.S.C. § 482. The Secretary in turn promulgated regulations authorizing the Commissioner to allocate income and deductions among related entities. The introduction to these regulations explains:

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes

> with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482.

26 C.F.R. § 1.482-1(a)(1).[4] The next subsection states that the standard to be employed "in every case" to ensure taxpayers accurately reflect income from controlled transactions and do not avoid taxes through such transactions is an arm's length standard:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

26 C.F.R. § 1.482-1(b)(1).

Another section, however, specifically governing cost sharing agreements between controlled parties to develop intangible property authorizes the Internal Revenue Service "to make

[4]Controlled taxpayer is defined as "any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers." 26 C.F.R. § 1.482-1(i)(5).

each controlled participant's share of the costs (as determined under [§ 1.482-7(d)]) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development . . . ." 26 C.F.R. § 1.482-7(a)(2). Controlled participants must include "all" costs in the pool of costs to be shared proportionally (the "all costs requirement"):

> For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of: operating expenses, as defined in § 1.482-5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482-5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement.

26 C.F.R. § 1.482-7(d)(1). "Operating expenses" are defined as "includ[ing] all expenses not included in cost of goods sold except for interest expense, foreign income taxes [and] domestic income taxes, and any other expenses not related to the operation of the relevant business activity." 26 C.F.R. § 1.482-5(d)(3). How these various provisions interact is the crux of the parties' dispute.

[1] Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's length would behave. The language is unequivocal: this arm's length standard is to be applied "in every case." In the context of cost sharing agreements, this would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, § 1.482-7(d)(1) specifies that controlled parties in a cost sharing agreement must share *all* "costs . . . related to the intangible development area," and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision's plain language mandates a different result. Accordingly, we conclude the two provisions establish distinct and irreconcilable standards for determining which costs must be shared between controlled parties in cost sharing agreements specifically related to intangible product development.

The structure of the regulatory regime confirms this conclusion. Section 1.482-1(b)(2) explains that "[s]ections 1.482-2 through 1.482-6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result." Section 1.482-1(c)(1)'s "best method rule" explains how the Commissioner and taxpayers should determine which of these methods provides the most reliable measure of the arm's length result: "the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of data and assumptions used in the analysis." Notably, § 1.482-7 is not included among the methods specified in § 1.482-1(b)(2) for determining the arm's length result, and the comprehensive definition of "costs . . . related to the intangible development area" does not implicate the factors identified in § 1.482-1(c)(1). Thus, §§ 1.482-1 through 1.482-6 establish a sophisticated methodology for comparing controlled transactions to uncontrolled transactions that is generally applicable when determining what items must be allocated among related parties. The regulatory regime then addresses a particular type of controlled transaction — cost sharing agreements related to intangible product development — and establishes a comprehensive definition of what costs must be shared that does not turn on similar uncontrolled transactions. Section 1.482-7 thus appears to be a self-contained provision creating an exception to the general methodology established in the earlier provisions. As long as taxpayers comply with the requirement of sharing all intangible development costs proportionally to the expected benefit, *see* 26 C.F.R. § 1.482-7(b)(2) (requiring "each participant's share of intangible development costs . . . reflect that participant's share of anticipated benefits"), they are assured the district director will not "make allocations" and revise the claimed tax liability attributable to the cost sharing agreement, 26 C.F.R. § 1.482-7(a)(2). A bright line rule governs what costs must be shared, rather than comparing the cost sharing agreement to similar agreements between unrelated parties.

In fact, the regulatory history suggests the Secretary viewed cost sharing agreements related to intangible product development as a unique type of controlled transaction meriting a distinct method of analysis. The 1986 amendments to 26 U.S.C. § 482 reflected Congress' particular concern over transfers and licenses of intangible property, but the conference committee report explaining those amendments recognized that "many important and difficult issues under section 482 [we]re left unresolved by this legislation" and suggested "a comprehensive study of intercompany pricing rules . . . should be conducted" and "careful consideration should be given to whether the existing regulations could be modified in any respect." H.R. Conf. Rep. No. 99-841, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4726. In response, the Internal Revenue Service and Treasury Department conducted a detailed study of controlled party transactions, publishing its results in 1988. *See* I.R.S. Notice 88-123, 1988-2 C.B. 458. The study "primarily considered transfers of intangibles, but it also addressed the application of section 482 to other transactions," including cost sharing agreements. Intercompany Transfer Pricing and Cost Sharing Regulations Under Section

482, 57 Fed. Reg. 3571, 3572 (proposed Jan. 30, 1992). The Secretary then promulgated the precursors of §§ 1.482-1 through 1.482-6 and § 1.482-7 in 1992 as a single proposed regulation, *id*., but did not finalize the comprehensive all costs requirement in § 1.482-7(d)(1) until December 1995, *see* T.D. 8632, 1996-4 I.R.B. 6, six months after the rest of the Section 482 regulations were finalized, *see* T.D. 8552, 1994-31 I.R.B. 4. The Secretary's separate regulatory action addressing cost sharing agreements related to intangible product development lends further support to our conclusion that the all costs requirement is different from the arm's length standard generally applicable to other controlled transactions.[5]

[2] Because the all costs requirement is irreconcilable with the arm's length standard, we hold § 1.482-7(d)(1) controls, in light of the "elementary tenet of statutory construction that where there is no clear indication otherwise, a specific statute will not be controlled or nullified by a general one," *Santiago Salgado v. Garcia*, 384 F.3d 769, 774 (9th Cir. 2004) (citations and internal quotation marks omitted); *see also Long*

[5]The parties and amici spend considerable time parsing the legislative history of 26 U.S.C. § 482. The statute, however, simply delegates authority to the Secretary to adjust taxable income of controlled parties to prevent tax evasion. It prescribes no particular methodology for doing so, except in the case of transfers and licenses of intangible property (types of transactions not at issue in this case), and does not mention cost sharing agreements. The 1986 conference committee report acknowledged the 1986 amendments did not resolve every problem inherent in controlled transactions and suggested the Secretary study the issue further and refine the regulations as needed, which the Secretary did. Congress plainly did not resolve how cost sharing agreements related to intangible development should be evaluated, and we decline the parties' invitation to interpret the regulations by attempting to divine a hypothetical intent from a statute that is silent on the issue we face. *See Pac. Nw. Generating Coop v. Dep't of Labor*, 550 F.3d 846, 860-61 (9th Cir. 2008) ("When relevant statutes are silent on the salient question, we assume that Congress has implicitly left a void for the agency to fill, and, therefore, we defer to the agency's construction of its governing statutes, unless that construction is unreasonable." (internal quotation marks and alteration omitted)).

Island Care at Home, Ltd. v. Coke, 127 S.Ct. 2339, 2348 (2007) (applying this canon of construction to regulations). Section 1.482-7 applies to cost sharing agreements related to intangible development, which is the particular controlled transaction at issue here, and specifies that "all costs . . . related to the intangible development area" must be included in the pool of costs to be shared. The general requirement in § 1.482-1(b)(1) that the arm's length standard should apply in every case involving a controlled transaction does not override such a specific provision.[6]

We are not persuaded by either party's attempts to harmonize the two provisions. Xilinx argues that § 1.482-1(b)(1)'s "in every case" language requires us to construe § 1.482-7(d)(1)'s all costs requirement to mean that parties must share only those costs that parties operating at arm's length would share, suggesting § 1.482-7(d)(1) did not explicitly incorpo-

[6]The dissent of our learned colleague, for whom we have the greatest respect, contends we should instead apply the canon of construction that doubts about the meaning of tax provisions should be resolved against the government. Dissent at 6181 (citing *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 839 (Thomas, J., concurring)). This canon, however, applies where language in a revenue provision is ambiguous. *See, e.g.*, *Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 348-49 (1927) (interpreting meaning of "proceeding" in tax provision establishing statute of limitations for collection of back taxes); *United States v. Merriam*, 263 U.S. 179, 184 (1923) (interpreting meaning of "bequest" to determine if gift was taxable income). We have not found any case resorting to this canon to resolve a conflict between two unambiguous tax provisions.

In any event, it is not the only canon of construction relevant to revenue provisions. There is a countervailing tradition under which tax provisions that merely create "an exception from a general revenue duty for the benefit of some taxpayers" are construed in favor of the government. *United Dominion*, 532 U.S. at 839 n.1 (Stevens, J., dissenting) (citing cases). In this case, we are determining how related parties in a cost sharing agreement must apportion business costs, which offset taxable income as a deduction under 26 U.S.C. § 162(a). Thus, even if these competing canons apply when two unambiguous provisions conflict, it would be more appropriate to resolve the conflict in favor of the government.

rate an arm's length standard because that requirement is implicit, and controlling, in light of § 1.482-1(b)(1). Although this explanation at first seems plausible, we are not ultimately persuaded. To read such a qualification into the precise and comprehensive language of §§ 1.482-5(d)(3) and 1.482-7(d)(1) would ignore the plain meaning and context of the cost sharing provisions, specifically "all" costs "related to" intangible development. "All" means "the entire number, amount or quantity" or "every," *American Heritage College Dictionary* 35 (3d ed. 2000), and "related" means "[b]eing connected [or] associated," *id*. at 1152. These terms, taken together with the regulation's sub-definitions, describe a fixed set of costs that must be shared in their totality and that will not vary based on the type of intangible property being developed. Transporting an arm's length standard into § 1.482-7(d)(1) would transform this apparently all encompassing and self-contained *description* of the costs to be shared into a *methodology* under which the costs to be shared would not be fixed by these defined terms but would rather ultimately be defined by the conduct of unrelated parties. Significantly, achieving an arm's length result is not itself the regulatory regime's goal; rather, its purpose is to prevent tax evasion by ensuring taxpayers accurately reflect taxable income attributable to controlled transactions.[7] *See* 26 C.F.R. § 1.482-1(a)(1). During the regulatory process, the Secretary concluded cost sharing agreements related to intangible development merited separate attention. The plain language in the finalized § 1.482-7 articulates a bright line rule, which appears to reflect a judgment that intangible product development through cost sharing agreements presents a special case

[7]Although the second sentence of § 1.482-1(a)(1) does note that Section 482 places controlled taxpayers on a tax parity with uncontrolled taxpayers, the first sentence of § 1.482-1(a)(1) states that "[t]he purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." Thus, we disagree with our dissenting colleague that the regulatory regime's singular purpose is to ensure tax parity. Dissent at 6180.

requiring a distinct approach to ensure related parties do not evade taxes. Under the circumstances, we are reluctant to import a general standard into a comprehensive definition contained in a highly specific regulation.[8]

On the other hand, the Commissioner argues that the word "generally" in § 1.482-1(b)(1) means there are exceptions to using "the results of comparable transactions under comparable circumstances" to determine the arm's length result and that § 1.482-7(d)(1)'s all costs requirement is such an exception. In context, however, the sentence containing the language quoted above conveys that identical transactions between unrelated parties — which are the ideal for determining "the results that would have been realized if controlled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)," § 1.482-1(b)(1) — are rare, so comparable transactions are "generally" the only feasible way to determine the arm's length result. Moreover, § 1.482-1(b)(2) does not list § 1.482-7 among the sections providing specific methods for calculating the arm's length result, so the Commissioner's suggestion that § 1.482-7(d)(1)'s all costs requirement is simply another method of determining the arm's length result is implausible. *See Boudette v. Barnette*, 923 F.2d 754, 756-57 (9th Cir. 1991) (holding "when a statute designates certain . . . manners of operation, all omissions should be understood as exclusions"). Finally, the Commissioner has presented no evidence that any companies operating at arm's length share ESO costs and does not challenge the tax court's finding that unrelated par-

[8]We do not address the parties' dispute over whether we should defer to the Commissioner's interpretation of the regulations, which was not announced until these tax proceedings began. *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212-13 (declining to defer to proffered agency interpretation that "appear[ed] to be nothing more than an agency's convenient litigating position"). We conclude the all costs requirement is not affected by unrelated parties' conduct based on the regulatory regime's plain language, structure and development, not on the Commissioner's proffered construction.

ties would not do so. 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. *See* 26 C.F.R. § 1.482-1(b)(1) (defining "arm's length result" as consistent "with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances").[9]

We also disagree with the dissent that the United States-Ireland Tax Treaty and the Treasury Department's Technical Explanation of that treaty are useful "guides" in determining which of the two irreconcilable standards governs.[10] Dissent at 6181-84. To be sure, the Technical Explanation, which was issued while the tax regulations at issue in this case were in effect, states that the treaty incorporates the arm's length principle from United States tax law, "refers to the arm's length standard as decisive" and "makes no specific mention of the

[9]The arm's length standard is a regulatory gloss on the Secretary's statutory authority to allocate income to avoid tax evasion, and the Secretary has since modified the regulations to state explicitly that ESOs are costs that must be shared and that the all costs requirement is an arm's length result, *see* 26 C.F.R. § 1.482-7T(a) & (d)(1)(iii) (2009), despite the absence of any evidence that unrelated parties share ESOs. Congress and regulators may adopt a technical definition of a term that is distinct from its plain meaning, *see, e.g., Ernzen v. United States*, 922 F.2d 1433, 1436 (9th Cir. 1991) (discussing technical statutory definition of "contribution" in 26 U.S.C. § 72(r)), but we are concerned here only with the regulations in effect in 1997, 1998 and 1999, which did not explicitly define an "arm's length" result to require sharing of ESOs.

[10]Although the dissent does not argue the treaty and Technical Explanation trump § 1.482-7, it maintains those documents can "obviate a potential conflict" between the regulations. Dissent at 6186. This is possible, however, only if they override § 1.482-7's plain language, and the dissent cites no authority in support of the novel proposition that an agency's interpretation of a treaty should supplant a duly enacted regulation. Treaty interpretations are undoubtedly entitled to great weight when construing an ambiguous treaty, *see Sumitomo Shoji Am., Inc. v. Avagliano*, 457 U.S. 176, 184-85 (1982), but § 1.482-7 was promulgated through notice-and-comment rulemaking and therefore has the force and effect of law, *see United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001).

[all costs requirement].” Dissent at 6183-84.[11] The dissent maintains the general arm’s length standard should trump the specific all costs requirement because it is hard to believe the Treasury Department “conceal[ed] from its treaty parties that [the arm’s length standard] had an exception when stock options were in question.” Dissent at 6185. But this argument rests on the false premise that Treasury officials involved in the treaty negotiations believed the all costs requirement was inconsistent with the arm’s length standard articulated in §§ 1.482-1 through 1.482-6. The dissent overlooks several details: (1) the Commissioner has always argued, before the tax court and on appeal, that the all costs requirement is consistent with the arm’s length standard in § 1.482-1(b)(1); (2) the Treasury Department has never publicly differentiated between the two standards; and (3) the current regulations explicitly state the all costs requirement is consistent with the arm’s length standard, *see* 26 C.F.R. § 1.482-7T(a) & (d)(1)(iii) (2009). By all appearances, the Treasury Department’s consistent view over the years has been that requiring related parties in a cost sharing arrangement to share ESO costs is not incompatible with (1) international norms or (2) the regulatory arm’s length standard under domestic tax law. Obviously, we have concluded the second view is not supported by the plain language of the regulations in effect during 1997, 1998 and 1999 (and we express no opinion on the first). But the dissent goes a step further by projecting our conclusion 12 years into the past and assuming the Treasury officials involved in negotiating and interpreting the tax treaty agreed with it, without offering any basis for doing so. As we have explained, we do not believe the Secretary accidentally

[11]These observations are not materially different from § 1.482-1(b)(1)’s statement that the arm’s length standard applies “in every case.” The dilemma in this case is that the arm’s length standard, as articulated by the tax regulations in effect at the time the Technical Explanation was issued, is irreconcilable with the all costs requirement. A document that essentially mirrors language in the general regulation stating the general standard should always govern does not, in our view, offer much insight into which of two conflicting regulations should control.

promulgated a highly specific regulation that plainly requires related parties in cost sharing agreements to share all costs. The treaty documents do not alter our view.

[3] In sum, we conclude the arm's length regulation, § 1.482-1(b)(1), and the all costs regulation, § 1.482-7(d)(1), cannot be harmonized. Accordingly, we hold § 1.482-7(d)(1), being the more specific of the two, controls.

B. Section 1.482-7(d)(1) Does Not Violate the United States-Ireland Tax Treaty.

[4] As noted, we requested supplemental briefing on whether § 1.482-7(d)(1) might be preempted for the tax years the United States-Ireland Tax Treaty was in effect. The tax treaty establishes that the appropriate standard for determining whether to reallocate profits from controlled transactions involving controlled parties is whether "conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises." *See* 1997 United States-Ireland Tax Treaty, Art. 9, RIA Int. Tax Treaty 3057. The Department of the Treasury's treaty explanation confirms that this standard is identical to the arm's length standard in § 1.482-1(b)(1). *See* Department of the Treasury Technical Explanation of the 1997 United States-Ireland Tax Treaty, RIA Int. Tax Treaty 3095. Nonetheless, § 1.482-7(d)(1) does not conflict with the tax treaty in these circumstances, because the treaty expressly allows a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty. *See* 1997 United States-Ireland Tax Treaty, Art. 1(4), RIA Int. Tax Treaty 3057 ("Notwithstanding any provision of [this treaty], a Contracting State may tax its residents . . . and its citizens, as if the [treaty] had not come into effect."). Xilinx is not a foreign entity, so applying § 1.482-7(d)(1) to it does not violate the treaty, even if the regulation's all costs requirement is at odds with the treaty's arm's length standard.

C. ESOs for Which Companies Claim Tax Deductions Are Costs and Are Related to the Research and Development Activity, to the Extent They Are Given to Employees Involved In or Supporting that Activity.

Because § 1.482-7(d)(1) controls, the Commissioner properly allocated the ESO amounts only if they are "costs incurred by [Xilinx] related to the intangible development area."

1. Certain ESO amounts are a cost.

Xilinx relies on the considerable evidence and testimony presented to the tax court that unrelated parties in a cost sharing agreement do not treat ESOs as costs to be shared. This evidence is beside the point — whether or not unrelated parties share an item is immaterial to whether it is a cost to either party. Xilinx also maintains ESOs are not costs because two provisions of § 1.482-7 allow taxpayers to use any accounting method as long as it is used consistently.[12] Xilinx reads these provisions to allow a taxpayer to establish conclusively what is or is not a cost by using a particular accounting method and sticking with it. Xilinx then argues that under one particular business accounting method, which was widely accepted when Congress passed 26 U.S.C. § 482 in the 1980s and was still an acceptable method during the tax years at issue, ESOs are not treated as costs.

[5] Xilinx's argument that § 1.482-7's accounting requirements allow taxpayers to self-define what is and is not a cost

[12]Those two subsections establish accounting requirements that taxpayers in a qualified cost sharing agreement must meet. First, they must "use a consistent accounting method to measure costs and benefits." 26 C.F.R. § 1.482-7(i). Second, they must maintain documentation to establish "[t]he accounting method used to determine the costs and benefits of the intangible development . . . and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences." 26 C.F.R. § 1.482-7(j)(2)(i)(D).

by consistently using a particular accounting method is creative but unsound. The accounting requirements are minimum eligibility requirements for a qualified cost sharing agreement. It does not logically follow that whatever accounting method a taxpayer uses, even a nonstandard one, conclusively establishes what is a cost, even if that method differs from how the regulation defines costs. Rather, the regulation's accounting requirements are clearly intended to ensure the government has a basis upon which to verify whether taxpayers who obtain the benefit of a qualified cost sharing agreement are accurately reporting and sharing costs, i.e., not treating items that are costs under the regulation as something other than costs.

Also, the official accounting method upon which Xilinx relies, Accounting Principles Board Opinion No. 25 (1972) ("APB 25"), was superseded by Statement of Financial Accounting Standards No. 123 (1995) ("SFAS 123"). Although SFAS 123 allowed taxpayers to employ APB 25's methodology (under which these ESOs have zero cost) during the relevant tax years, SFAS 123 explained that the APB 25 method was no longer the preferred method for valuing ESOs, going so far as to require companies employing APB 25 also to report the cost of ESOs under SFAS 123's preferred fair value based method. Xilinx used APB 25 and treated the ESOs as a zero cost on its books, but it also complied with SFAS 123 and reported the ESO cost under the SFAS 123 fair value method in footnotes to its public income statements. Thus, although Xilinx did not violate business accounting practices in ascribing zero cost on its books to ESOs, the preferred business accounting practice during the relevant tax years treated ESOs as costs.

[6] In the end, Xilinx's argument is undermined by the regulatory language and its own tax returns. "Costs incurred related to the intangible development area [are] . . . operating expenses as defined in § 1-482.5(d)(3)," 26 C.F.R. § 1.482-7(d)(1), which provides that "operating expenses" include "all expenses not included in cost of goods sold except for . . . any . . . expenses not related to the operation of the relevant business activity," 26 C.F.R. § 1-482.5(d)(3).[13] Xilinx stipulated that it did not include the value of the ESOs in the cost of goods sold, and it claimed tax deductions under 26 U.S.C. §§ 83 and 162 for the exercised NSOs and the disqualifying dispositions of the ISOs and ESPPs as business "expenses."[14] *See* 26 U.S.C. § 162(a)(1) (allowing employers to deduct "all the ordinary and necessary *expenses* paid or incurred" (emphasis added)). Xilinx could not have claimed deductions on these ESOs unless they were an "expense," which is the key term in the definition of "cost" under § 1.482-7(d)(1). Moreover, Xilinx required XI to pay it for the value of the ESOs XI employees exercised. Requiring reimbursement for ESOs granted to another company's employees further supports the conclusion that the ESOs are costs. In short, the preferred business accounting method in effect during the relevant tax years treated ESOs as costs, and Xilinx itself treated certain amounts of ESOs as "expenses" in claiming them as a tax deduction. Accordingly, we hold the ESO value that Xilinx deducted as a business expense is a "cost" for the purposes of § 1.482-7(d)(1).[15]

---

[13]For the sake of clarity, we analyze whether the ESOs are a "cost" and whether they are "related to" the joint venture separately. We recognize that this distinction is not altogether appropriate, because the meaning of "cost" turns on whether an item is an "operating expense," the definition of which focuses on whether the expense is "related to" the "relevant business activity." The proper construction of "cost" therefore turns on whether it is "related to" the activity. Because we conclude ESOs are "related to" the intangible product development area, however, our separate analysis of the two questions poses no problem.

[14]The Commissioner stipulated that the exercise (as opposed to disqualifying dispositions) of ISOs and ESPPs are not "operating expenses" within the meaning of § 1.482-5(d)(3). Accordingly, we have no occasion to decide whether those items are "costs" that must be shared.

[15]Xilinx also suggests the ESOs should not be treated as costs because they require no cash outlay. Presumably, however, Xilinx could obtain full market value for the stock shares it allows its employees to obtain at a lower price, so, at a minimum, the difference between the exercise price and the then-current market price is an opportunity cost to Xilinx. In any event, ESOs were treated as costs during the relevant tax years under tax accounting principles and the preferred business accounting methodology.

2. *ESOs are related to the intangible development area.*

[7] The tax court found the ESOs are part of Xilinx's employee recruitment and retention program, and Xilinx does not suggest salaries or benefits, like healthcare and retirement contributions, for employees involved in R&D activities are not "related to" their work on the R&D activities. It is difficult to view ESOs as anything but part of Xilinx's employee compensation package, because it is a benefit conferred in exchange for services rendered. ESOs are just as "related to" ("connected [or] associated" with) an employee's work as any other employment benefit or compensation. *See American Heritage College Dictionary* 1152 (3d ed. 2000). In fact, Xilinx claimed the ESOs as part of a tax credit available for "wages paid or incurred to an employee for qualified [research] services performed by such employee." 26 U.S.C. § 41(b)(2)(A). Xilinx's inclusion of ESOs as part of employee wages for the R&D tax credit undermines its attempt to avoid tax liability by arguing those ESOs are not "related to" the same research activity. Although "related to" in 26 C.F.R. § 1.482-7(d)(1) and "for" in 26 U.S.C. § 41(b)(2)(A) are not identical terms, they convey essentially the same thing in the context of each provision: the expense must be part of the compensation given to an employee involved in the relevant activity.

Accordingly, Xilinx's arguments that its ESOs have nothing to do with R&D, are issued company wide and are not viewed by the employees who receive them as related to their R&D are misplaced. The same can be said of any component of an employee's compensation package. For example, health benefits given to a company's employees are not tied to any particular task an employee performs, yet the cost of those benefits borne by the employer is still related to the work its employees do. (The cost of health benefits was specifically included among the items to be shared between Xilinx and XI as part of the total R&D costs.) For employees who work on

R&D, the cost of health benefits for that employee is plainly related to the company's R&D activities.

Xilinx also focuses on the considerable evidence it presented to the tax court proving companies operating at arm's length do not share the cost of ESOs. It maintains those companies would share ESO costs if they were in fact related to a joint venture, just as they share all other costs related to the project, and points out that not even the United States allows contractors hired to conduct R&D to bill the government for the cost of ESOs. Xilinx believes the reason companies operating at arm's length do not share ESOs must be that the cost is not related to the joint venture. The evidence presented to the tax court, however, suggests three reasons why companies operating at arm's length do not share ESO costs, none of which have anything to do with whether the cost is related to the joint venture. First, as Xilinx has pointed out, unlike most costs, companies bear no out-of-pocket expense for ESOs (in fact, the exercise of ESOs results in cash inflow). Even though companies can estimate the accounting cost of ESOs, the tax court found those costs cannot be measured *precisely*, so companies operating at arm's length may elect not to share ESOs, because agreeing how to value something with no present out-of-pocket cost might be a sticking point in negotiating an agreement. Second, the tax court noted the cost of ESOs is tied to the value of one company's stock, so sharing this cost might create a perverse incentive for the other company to minimize the economic value of the joint venture in order to keep its partner's stock value low and thereby limit its own share of the cost for its partner's ESOs. Finally, a company operating at arm's length has an incentive *not* to share ESO costs, to the extent those costs can be deducted as a business expense. What company would not like to bear the full cost of something that imposes no out-of-pocket expense and confers the benefit of a tax deduction? Although the record conclusively establishes that companies in a joint venture operating at arm's length do not share ESO costs, none of the possible explanations for this fact demonstrate ESO costs are unrelated to the joint venture.

[8] Accordingly, we hold ESOs are related to the work performed by the employees who receive them. The ESO costs for employees who were involved in activities that would contribute to the joint venture between Xilinx and XI therefore should have been shared. Based on the record before us, however, we cannot conclusively determine whether the Commissioner's allocation is limited only to employees involved in the joint venture and takes into account whether employees spent all or only part of their time on tasks relevant to the joint venture. Accordingly, we remand to the tax court on the narrow issue of determining whether the Commissioner's allocation accurately reflects ESO costs for employees involved in tasks related to the joint venture.

IV. CONCLUSION

We hold that 26 C.F.R. § 1.482-7(d)(1)'s all costs requirement is irreconcilable with 26 C.F.R. § 1.482-1(b)(1)'s requirement that an arm's length standard should apply in every case and that § 1.482-7(d)(1), as the more specific of the two provisions, controls. We further hold ESOs are "costs . . . related to the intangible development area" and therefore must be shared between controlled parties in a cost sharing agreement. We therefore reverse the tax court, because the Commissioner's allocation was appropriate to the extent it involved ESO costs Xilinx claimed as a business expense deduction and was limited to ESOs for employees involved in the joint venture. We remand so that the tax court may ensure the Commissioner's allocation is consistent with our holding.

[9] Xilinx may have been caught off guard by the deficiency notices, which is understandable given the absence of any public guidance that the Commissioner would interpret the cost sharing regulation to require sharing of ESO costs. This result is nonetheless mandated by the plain meaning of

§ 1.482-7(d)(1), which we have concluded controls over § 1.482-1(b)(1). We are troubled, however, by the imposition of accuracy related penalties here. Although we have construed the regulations in a manner favorable to the Commissioner, we rejected the Commissioner's attempted harmonization of §§ 1.482-1 and 1.482-7 along the way. Moreover, the Secretary has since promulgated new regulations "clarify[ing]" this issue by explicitly including ESOs as costs to be shared.[16] 68 Fed. Reg. 51171-02, 2003-2 C.B. 841. When even the government has found it necessary to clarify the regulations, we have our doubts that imposing a penalty on taxpayers for their failure to follow the letter of the law is appropriate. On remand, the tax court may also consider any defenses Xilinx raised against the Commissioner's imposition of accuracy related penalties.

REVERSED and REMANDED.

NOONAN, Circuit Judge, dissenting:

The Commissioner of Internal Revenue has issued regulations that are irreconcilable. These are the regulations relevant to this case. We have three alternatives:

1. Hold that when the Commissioner talks out of both sides of his mouth, his speech is unintelligible and his regulations are unenforceable.

---

[16]The current temporary regulations provide that controlled taxpayers' operating costs, which must be shared in a qualified cost sharing arrangement, "include . . . stock-based compensation." 26 C.F.R. § 1.482-7T(d)(1)(iii) (2009). Such expenses must "equal . . . the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation." 26 C.F.R. § 1.482-7T(d)(3)(iii) (2009).

2. Apply a rule of thumb: the specific controls the general.

3. Resolve the conflict based on the dominant purpose of the regulations, aided by the basic rule that ambiguous documents are to be interpreted against the drafter and further enlightened by the way the Treasury has proceeded in drafting tax treaties relevant to American parents and their foreign subsidiaries.

The majority has chosen the second alternative. It is a simple solution. It is plausible. But it is wrong. It converts a canon of construction into something like a statute. It ignores the international context and the Treasury's own practice. In what follows, I will spell out this mistake and why I chose the third alternative.

The problem. The majority put it well:

> Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's length would behave. The language is unequivocal: this arm's length standard is to be applied "in every case." In the context of cost sharing agreements, this would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, § 1.482-7(d)(1) specifies that controlled parties in a cost sharing agreement must share *all* "costs . . . related to the intangible development area," and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision's plain language mandates a different result. Accordingly, we conclude the two provisions establish distinct and irrec-

> oncilable standards for determining which costs must be shared between controlled parties in cost sharing agreements specifically related to intangible product development. Maj. Op. 6162-63.

The handy canon of construction. Often the specific controls the general. This rule has been used by the Supreme Court. *E.g.*, *Long Island Care At Home, Ltd. v. Coke*, 127 S. Ct. 2339, 2348 (2007). Apply this simple rule here, and section 1.482-7(d)(1) controls. The conflict dissolves. The Commissioner is vindicated.

This simple solution is all too pat. It gives controlling importance to a single canon of construction. But, as every judge knows, the canons of construction are many and their interaction complex. The canons "are not mandatory rules." *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001). They are guides "designed to help judges determine the Legislature's intent." *Id.* They can be "overcome" by "other circumstances" manifesting that intent. *Id.* The canons are "tools designed to help courts better determine what Congress intended, not to lead courts to interpret the law contrary to that intent." *Scheidler v. National Org. of Women, Inc.*, 547 U.S. 9, 23 (2006). In the light of these principles, three considerations show the Commissioner's position to be untenable.

Purpose. First, the purpose of the regulation is paramount. That purpose is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm's length is trumped by 7(d)(1) the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have parity with an independent taxpayer. Under the majority's holding, the law is interpreted contrary to the intent of its maker.

A basic rule. Second, a very old canon of construction applies in this case, "in which the complex statutory and regulatory scheme leads itself to any number of interpretations." We resolve the inconsistencies against the government. *United Dominos Industries, Inc. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J., concurring and citing, among other cases, *United States v. Merriam*, 263 U.S. 179, 188 (1923) ("If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer")). This canon of construction is framed in the cases just cited as particularly relevant to tax statutes. It is, however, not a concession to taxpayers. It is the way legal documents are read. The draft is construed against the drafter.

Treasury practice. The purpose of the regulations and the normative rules of interpretation deny recognition to the Commissioner's position on 7(d)(1). Additionally, his own agency has undercut him in the tax treaty between the United States and Ireland, signed into law by President Clinton on July 28, 1997. The announced purpose of the tax treaty is "the avoidance of double taxation and the prevention of fiscal evasion with respect to income and capital gains."

The treaty reads:

Article 9 Associated Enterprises

1. Where:

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two

> enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then, any profits that, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
>
> 2. Where a Contracting State includes in profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the other Contracting State agrees that the profits so included are profits that would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those that would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

1997 United States-Ireland Tax Treaty, RIA Int. Tax Treaty 3057.

The treaty adopts as its standard the transactions "that would be made between independent enterprises." That standard is the arm's length standard. No exceptions are provided. Arm's length is the international standard specifically governing Xilinx and XI.

A tax treaty is negotiated by the United States with the active participation of the Treasury. The Treasury's reading of the treaty is "entitled to great weight." *United States v. Stuart*, 489 U.S. 353, 369 (1989) (quoting *Sumitomo Shoji America, Inc. v. Aragliano*, 457 U.S. 176, 184-185 (1982)). Simultaneous with the signing of the treaty into law, the Treasury issued its "Technical Explanation." As to Article 9, the Explanation reads:

> This article incorporates in the Convention the arm's length principle reflected in the U.S. domestic transfer pricing provision, particularly Code section 482. It provides that when related enterprises engage in a transaction on terms that are not arm's length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related enterprises to reflect what the income and tax of these enterprises with respect to the transaction would have been had there been an arm's length relationship between them.
>
> . . .
>
> The fact that a transaction is entered into between such related enterprises does not, in and of itself mean that a Contracting State may adjust the income (or loss) of one or both of the enterprises under the provisions of this Article. If the conditions of the transaction are consistent with those that would be made between independent persons, the income arising from that transaction should not be subject to adjustment under this Article.
>
> Similarly, the fact that associated enterprises may have concluded arrangements, such as cost sharing arrangements or general services agreement, is not in itself an indication that the two enterprises have entered into a non-arm's length transaction that

> should give rise to an adjustment under paragraph 1. Both related and unrelated parties enter into such arrangements (e.g., joint venturers may share some development costs). As with any other kind of transaction, when related parties enter into an arrangement, the specific arrangement must be examined to see whether or not it met the arm's length standard. In the event that it does not, an appropriate adjustment may be made, which may include modifying the terms of the agreement or recharacterizing the transaction to reflect its substance.
>
> It is understood that the "commensurate with income" standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard. The implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines.

Department of the Treasury Technical Explanation of the 1997 United States-Ireland Tax Treaty, RIA Int. Tax Treaty 3095.

No fewer than five times, the Explanation refers to the arm's length standard as decisive. The Explanation adds that as to "transaction[s] . . . that are consistent with those that would be made between independent persons, the income from the transfer should not be subject to adjustment under this Article." The Explanation makes no specific mention of the "all-of-the-costs" standard. The Explanation glosses the statute's "commensurate with income standard" as "designed to operate consistently with the arm's length standard": the arm's length standard is treated as the measure, with which CWI is "designed to operate consistently." This standard is further affirmed to be in accord with principles operative under the Transfer Pricing Guidelines of the Organisation for Economic Co-operation and Development.

It cannot easily or safely be supposed that the Treasury in negotiating the treaty was unaware of the "all-of-the-costs" regulation and its relation to stock options issued in connection with R&D. In oral argument before this court, counsel for the Commissioner expressed the relation between the different divisions of the Treasury by tightly clasping his two hands together, a gesture effectively communicating their unity of thought and action. The Commissioner as litigator cannot disavow the position that the Treasury repeatedly took in the Ireland and other tax treaties of which we take judicial notice. *See, e.g.*, United States-France, Article 9 (RIA Int. Tax Treaty 2225); United States-Germany, Article 9 (RIA Int. Tax Treaty 1542); and United States-United Kingdom, Article 9 (RIA Int. Tax Treaty 2546). In each of them, Article 9 takes transactions between independent companies as the measure.

Using the standard of what independent companies would do in their own cost-sharing arrangements, the Treasury could not have meant to conceal from its treaty parties that this standard had an exception when stock options were in question. There is good reason for the standard the Treasury chose: it is an internationally comprehensible standard. It does not require the treaty partner to recognize costs that may have no recognition in its law. If double taxation of the income of parent and subsidiary is to be avoided, a clear, simple, comprehensive standard is needed.

I do not reach the issue of whether the treaty obligations "constitute binding federal law enforceable in United States courts." *Medellin v. Texas*, 128 S.Ct. 1346, 1356 (2008). Even if the treaty and the Technical Explanation should be held not to operate as law trumping the hapless regulation, 7(d)(3), treaty and explanation act as guides. They tell us what the Treasury has had in mind in the regulations at issue. They obviate a potential conflict. They illuminate what “tax parity” entails.

No remand is necessary. I vote to affirm the decision of the tax court.

ADDENDUM B

XILINX INC. AND SUBSIDIARIES, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent XILINX INC. AND CONSOLIDATED SUBSIDIARIES, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Nos. 4142-01, 702-03

UNITED STATES TAX COURT

125 T.C. 37; 2005 U.S. Tax Ct. LEXIS 24; 125 T.C. No. 4

August 30, 2005, Filed

SUBSEQUENT HISTORY: As Amended, September 29, 2005. As Amended, September 15, 2005.

SYLLABUS

[**1]

P entered into a cost-sharing agreement to develop intangibles with S, its foreign subsidiary. Each party was required to pay a percentage of the total research and development costs based on its respective anticipated benefits from the intangibles. P issued stock options to its employees performing research and development. In determining the allocation of costs pursuant to the agreement, P did not include in research and development costs any amount related to the issuance of stock options to, or exercise of stock options by, its employees. R, in his notices of deficiency, determined that for cost-sharing purposes, pursuant to sec. 1.482-7(d), Income Tax Regs., the spread (i.e., the stock's market price on the exercise date over the exercise price) or, in the alternative, the grant date value, relating to compensatory stock options, should have been included as a research and development cost.

1. Held: R's allocation is contrary to the arm's-length standard mandated by sec. 1.482-1(b), Income Tax Regs. [**2] , because uncontrolled parties would not allocate the spread or the grant date value relating to employee stock options.

2. Held, further, P's allocation satisfies the arm's- length standard mandated by sec. 1.482-1, Income Tax Regs.

COUNSEL: Kenneth B. Clark, Ronald B. Schrotenboer, William F. Colgin, Tyler A. Baker, Jaclyn J. Pampel, and Anthony D. Cipriano, for petitioners.

David P. Fuller, Jeffrey A. Hatfield, Bryce A. Kranzthor, Lloyd T. Silberzweig, Kendall Williams, David N. Bowen, John E. Hinding, and Paul K. Webb, for respondent.

JUDGES: Foley, Maurice B.

OPINION BY: Maurice B. Foley

OPINION

[*38] OPINION

FOLEY, Judge: Respondent determined deficiencies in the amounts of $ 24,653,660, $ 25,930,531, $ 27,857,516, and $ 27,243,975 and section 6662(a) accuracy-related penalties in the amounts of $ 4,935,813, $ 5,189,389, $ 5,573,412, and $ 5,448,795 relating to petitioners' 1996, [1] 1997, 1998, and 1999 Federal income taxes, respectively. The issues for decision are whether: (1) Petitioner and its foreign subsidiary must share the cost, if any, of stock options petitioner issued to research and development employees, (2) respondent's [**3] allocations meet the arm's-length requirement set forth in section 1.482-1(b), Income Tax Regs., and (3) petitioners are liable for section 6662(a) accuracy-related penalties.

1 Pursuant to the parties' Apr. 4, 2002, stipulation of settled issues, the 1996 taxable year is no longer in issue.

[*39] Background

I. Xilinx's Line of Business and Corporate Structure

Xilinx Inc., [2] is in the business of researching, developing, manufacturing, marketing, and selling field programmable logic devices, [3] integrated circuit devices, and other development software systems. Petitioner uses unrelated producers to fabricate and assemble its wafers into integrated circuit devices.

2 All references to "petitioner" are to Xilinx Inc. All references to "petitioners" are to Xilinx Inc. and its consolidated subsidiaries.

3 Field programmable logic devices are integrated circuits that can be programmed, using development software, to perform complex functions.

[**4] During the years in issue, petitioner was the parent of a group of affiliated subsidiaries including, but not limited to Xilinx Holding One Ltd., Xilinx Holding Two Ltd., Xilinx Development Corporation (XDC), NeoCAD Inc., [4] Xilinx Ireland (XI), and Xilinx International Corporation. XI was established in 1994 as an unlimited liability company under the laws of Ireland and was owned by Xilinx Holding One Ltd., and Xilinx Holding Two Ltd. (i.e., Irish subsidiaries of petitioner). XI was created to manufacture field programmable logic devices and to increase petitioner's European market share. It manufactured, marketed, and sold field programmable logic devices, primarily to customers in Europe, and conducted research and development.

4 NeoCAD Inc., was liquidated in 1998.

II. The Cost-Sharing Agreement

On April 2, 1995, petitioner and XI entered into a Technology Cost and Risk Sharing Agreement (cost-sharing agreement). The cost-sharing agreement provided that all "New Technology" developed by either petitioner [**5] or XI would be jointly owned. New Technology was defined as technology developed by petitioner, XI, or petitioner's consolidated subsidiaries, on or after the execution date of the cost-sharing agreement. Each party was required to pay a percentage of the total research and development costs based on the respective anticipated benefits from New Technology. The cost-sharing agreement further provided that each year the parties would review and, when appropriate, adjust such [*40] percentages to ensure that costs continued to be based on the anticipated benefits to each party.

Petitioner and XI were required to share direct costs, indirect costs, and acquired intellectual property rights costs. Direct costs were defined in the agreement as those costs directly related to the research and development of New Technology including, but not limited to, salaries, bonuses, and other payroll costs and benefits. Indirect costs were defined as those costs, incurred by other departments, that generally benefit all research and development including, but not limited to, administrative, legal, accounting, and insurance costs. Acquired intellectual property rights costs were defined as costs incurred in [**6] connection with the acquisition of products or intellectual property rights. In determining the allocation of costs pursuant to the cost-sharing agreement, petitioner did not include in research and development costs any amount related to the issuance of employee stock options (ESOs).

Cost-sharing percentages for petitioner and XI relating to 1997, 1998, and 1999 were as follows:

Year	Petitioner	XI

1997	73.61%	26.39%
1998	73.35	26.65
1999	65.09	34.91

In 1997, 1998, and 1999, the following number of petitioner's and XI's employees engaged in research and development:

Year	Petitioner	XI
1997	338	6
1998	343	10
1999	394	16

III. Petitioner's Stock Option Plans

ESOs are offers to sell stock at a stated price (i.e., the exercise price) for a [**7] stated period of time. They are used by many companies to attract, retain, and motivate employees and align employee and employer goals. There are basically three types of ESOs: statutory or incentive stock options (ISOs), nonstatutory stock options (NSOs), and purchase rights issued [*41] pursuant to an employee stock purchase plan (ESPP purchase rights). ISOs and NSOs allow employees to purchase stock at a fixed price for a specified period of time. ESPP purchase rights allow employees to purchase stock at a discount through the use of payroll deductions. ISOs and ESPP purchase rights receive special tax treatment and are typically not subject to tax when they are granted or exercised, but the stock acquired pursuant to the exercise of these options is subject to tax when such stock is sold. [5] NSOs, however, are, pursuant to section 83, [6] Property Transferred in Connection with the Performance of Services, subject to tax upon exercise unless the option has a readily ascertainable fair market value. [7] Sec. 83(a). If an NSO has a readily ascertainable fair market value, income is recognized on the grant date, and the issuer is entitled to a deduction. Sec. 83(h); sec. 1.83-7(a), Income Tax Regs. [**8]

5 Pursuant to secs. 422 and 423, respectively, ISOs and ESPP purchase rights are subject to a holding period requirement. This period begins on the exercise date and ends on the date that is the later of 2 years after the grant date or 1 year after the transfer of the share of stock. Secs. 422(a)(1) and 423(a)(1). If the employee disposes of the stock before the holding period expires, this disposition will be considered a "disqualifying disposition". A disqualifying disposition requires the employee to recognize ordinary income (i.e., equal to the stock's market price on the exercise date over the exercise price) in the taxable year in which the disposition occurred. Sec. 421(b).

6 Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

7 An option has a readily ascertainable fair market value if it is actively traded on an established market or the taxpayer can establish all of the following conditions: (1) The option is transferable by the optionee; (2) the option is exercisable immediately in full by the optionee; (3) the option is not subject to any restriction which has a significant effect on the fair market value of the option; and (4) the fair market value of the option privilege is readily ascertainable. Sec. 1.83-7(b)(1) and (2), Income Tax Regs. "Option privilege" is the value of the right to benefit from any future increase in the value of the property subject to the option, without risking any capital. Sec. 1.83-7(b)(3), Income Tax Regs.

[**9] NSOs, when granted, may be "in-the-money", "out-of-the-money", or "at-the-money". ISOs, however, may only be "at-the-money" or "out-of-the-money". [8] An option is deemed in-the-money when the exercise price on the grant date is below the stock's market price. Conversely, an option is out-of-the-money when the exercise price on the grant date is above the stock's market price. An option that has an exercise price equal to the stock's market price on the grant date is considered at-the-money.

8 Pursuant to sec. 422, the exercise price relating to ISOs may not be less than the stock's market price on the grant date. Sec. 422(b)(4).

[*42] An employee typically cannot exercise options, until the employee has a vested right (i.e., a legal right that is not contingent on the performance of additional services) in the option pursuant to the stock option plan's terms. Some companies permit immediate vesting upon issuance of an option, while others delay vesting several years or allow incremental vesting over a period of years.

[**10] Petitioner, pursuant to broad-based plans (i.e., plans that offer ESOs to 20 percent or more of a company's employees), offered three types of stock option compensation: ISOs, NSOs, and ESPP purchase rights. All ISOs and NSOs issued by petitioner were at-the-money. All ESPP purchase rights were issued with an exercise price equal to 85 percent of the stock's market price. Prior to and during the 1997 taxable year, the options were generally subject to a 5-year vesting period. After 1997, petitioner decreased the vesting period from 5 to 4 years.

Pursuant to the stock option plan, employees could exercise options by delivering to petitioner's broker a notice of exercise with irrevocable instructions and consideration equal to the exercise price. The broker would then deliver the instructions and consideration to petitioner. Employees could elect to exercise their options in either a "same-day-sale" or "buy-and-hold" transaction. In a same-day-sale, the employee does not make a payment for the stock relating to the option. Instead, simultaneous execution of the option and sale of the stock results in the excess of the stock's market price on the grant date over the exercise price going [**11] to the employee and the amount of the exercise price going to petitioner. In a buy-and-hold transaction, the employee pays the exercise price by presenting a check or other form of consideration to petitioner's broker and in exchange receives the shares of stock.

A. 1988 Stock Option Plan

In 1988, petitioner established the Xilinx 1988 Stock Option Plan (1988 Stock Option Plan). The 1988 Stock Option Plan provided for the grant of ISOs and NSOs. Under the 1988 Stock Option Plan, petitioner granted options as part of the employee hiring process and retention program. Petitioner also granted merit and discretionary stock options. Merit options were based on job performance and granted [*43] after an employee's annual review. Discretionary stock options were a separate pool of options made available to petitioner's vice presidents to reward their subordinates for significant project achievements.

Under the 1988 Stock Option Plan, former employees generally could exercise options if the exercise occurred within 30 days after the cessation of the employee's tenure at the company. In April of 1998, the 1988 Stock Option Plan was replaced by the Xilinx, Inc. 1997 Stock Plan (1997 [**12] Stock Option Plan). The 1997 Stock Option Plan provided for the grant of ESPP purchase rights in addition to ISOs and NSOs.

B. 1990 Employee Qualified Stock Purchase Plan

The Xilinx, Inc. 1990 Employee Qualified Stock Purchase Plan (ESPP) allowed full-time employees to purchase petitioner's stock at a discount. Beginning January 1, 1990, the ESPP provided 24-month offering periods which commenced during the beginning of January and July. Eligible employees could participate in the ESPP by completing a Subscription Agreement authorizing payroll deductions. During a 24-month offering period, employees could contribute to the plan through payroll deductions in any amount between 2 and 15 percent of their total compensation. Upon exercise, petitioner would deduct the exercise price from the employee's accumulated payroll deductions. The exercise price was equal to the lower of 85 percent of the stock's market price on the offering date (i.e., the first day of each offering period), or 85 percent of the stock's market price on the exercise date. Stock could be purchased twice a year (i.e., on June 30 and December 31).

Petitioner also maintained a stock buy-back program. Pursuant [**13] to the program, petitioner, during 1997, 1998, and 1999, purchased stock from stockholders and transferred such stock (i.e., treasury shares) to employees who had exercised options or purchased stock pursuant to petitioner's ESPP.

IV. Petitioner's Stock Option Intercompany Agreements With XI

On March 31, 1996, petitioner and XI entered into The Xilinx Ireland/Xilinx, Inc. Stock Option Intercompany Agreement. [*44] The purpose of the Stock Option Intercompany Agreement was to allow XI employees to acquire stock in petitioner. The Stock Option Intercompany Agreement provided that the cost incurred by petitioner for the grant or exercise of options by XI employees would be borne by XI. The cost equaled the stock's market price on the exercise date over the exercise price. Upon receipt of petitioner's notice specifying the appropriate amount, XI was required to pay petitioner.

On March 31, 1996, petitioner and XI also entered into the Xilinx, Inc./Xilinx Ireland Employee Stock Purchase Plan Reimbursement Agreement (ESPP Reimbursement Agreement), which allowed XI employees to purchase, with payroll deductions, petitioner's stock. XI was required to pay petitioner the cost associated with the [**14] exercise of the options. Pursuant to the agreement, the cost equaled the stock's market price on the exercise date over the exercise price. Upon receipt of petitioner's notice specifying the appropriate amount, XI was required to pay petitioner.

V. Financial Accounting Disclosure Rules

A. Background

The Financial Accounting Standards Board (FASB) is the professional organization primarily responsible for establishing financial reporting standards in the United States. FASB's standards are known as Generally Accepted Accounting Principles (GAAP). For more than 30 years, FASB has recognized certain ESOs as an expense to the issuing corporation.

B. Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25)

In 1972, FASB authorized APB 25, which required ESOs to be valued using the "intrinsic value method" (IVM). From 1972 to December 15, 1995, the IVM was the only authorized financial accounting method for valuing ESOs. Under the IVM, the value of ESOs is the excess of the stock's market price on the grant date over the exercise price. This value is reported directly on the employer's income statement relating to the year in which the ESOs [**15] are granted. ESOs granted at-the-money have no intrinsic value because the stock's market price on the grant date is equal to the exercise price.

[*45] C. Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" (SFAS 123)

In October of 1995, FASB issued SFAS 123, which is effective for fiscal years ending after December 15, 1995. SFAS 123 added the "fair value method" (FVM) as the preferred method for valuing ESOs. Pursuant to SFAS 123, companies continuing to use the IVM were required to "make pro forma disclosures of net income and, if presented, earnings per share, as if the * * * [FVM] had been applied."

The value of an ESO is composed of two components: the intrinsic value and the call premium. While the intrinsic value is equal to the stock's market price on the grant date over the exercise price, the call premium is the amount, in excess of an ESO's intrinsic value, that a purchaser would be willing to pay for the ESO. An ESO's call premium is difficult to measure because it, unlike the call premium of a publicly traded option, cannot be valued daily based on market transactions. FASB readily recognized that the IVM fails to measure adequately [**16] the call premium relating to ESOs. [9] Nevertheless, the IVM remained a permissible accounting method during the years in issue. Although the FVM was added as the preferred method in 1996, most companies continued to use the IVM during the years in issue.

9 FASB, in SFAS 123, stated: "Zero is not within the range of reasonable estimates of the value of employee stock options at the date they are granted, the date they vest, or at other dates before they expire."

Pursuant to the FVM, a corporation must measure the amount of the expense as equal to the fair value of the ESO on the grant date and amortize such expense over the vesting period. Under SFAS 123, fair value is measured using option pricing models that consider the following six attributes of equity-based instruments: (1)

The exercise price, (2) the expected life of the option, (3) the current price of the underlying stock, (4) the expected price volatility of the underlying stock, (5) expected dividends, and (6) the risk-free interest rate for the expected [**17] life of the option.

The FVM utilizes option pricing models, such as the Black Scholes model (BS model), for purposes of measuring the value of ESOs. The BS model was originally designed to measure publicly traded options and, as a result, fails to adequately take into account numerous differences between ESOs [*46] and publicly traded options. For example, ESOs are nontransferable and have terms to maturity that are usually longer than those of publicly traded options. The extended term of an ESO complicates the task of estimating the volatility of the stock price, which is an essential input in the pricing of any option. Furthermore, ESOs cannot be traded, so they must be discounted to account for the difference in value between tradeable and nontradeable options (i.e., tradeable options are worth more than nontradeable options). Yet, the appropriate discount is difficult to determine with reasonable accuracy because the discount is based on the value of the ESO to an employee. Moreover, an ESO's value is affected by whether an employee forfeits the option by failing to exercise it or exercises the option prior to the expiration of the ESO's maximum life. These employee decisions cannot [**18] be reliably modeled. Thus, FAS 123 requires companies to make certain adjustments to take into account the differences between ESOs and publicly traded options. For example, to account for option forfeiture, SFAS 123 requires that an ESO's value be discounted to reflect the amount of forfeitures expected annually. With respect to early exercise, the expected life of the option is used instead of the ESO's actual or maximum life.

During the years in issue, petitioners, on their Securities and Exchange Commission Forms 10-K, elected to use the IVM, as prescribed in APB 25, to measure expenses attributable to ESOs. As required by SFAS 123, petitioners disclosed net income and earnings per share as if the FVM had been applied. In determining the fair value of ESOs, petitioners used an adjusted BS model.

VI. Procedural History

A. Petitioners' Federal Income Tax Returns

Petitioners are accrual basis taxpayers and timely filed consolidated Federal income tax returns for their taxable years ended March 29, 1996, March 29, 1997, March 28, 1998, and April 3, 1999. During the years in issue, GAAP, pursuant to APB 25, provided that the issuing company did not incur an expense related to options [**19] granted at-the-money. In accordance with APB 25, petitioner did not, for [*47] purposes of its cost-sharing agreement with XI, include any costs related to ESOs issued to employees.

On December 28, 2000, and October 17, 2002, respondent issued notices of deficiency relating to 1996 through 1998 and 1999, respectively. In his notices of deficiency, respondent determined that petitioners were required, pursuant to its cost-sharing agreement, to share with XI the costs of certain ESOs. Respondent determined that the cost required to be taken into account equaled the spread (i.e., the stock's market price on the exercise date over the exercise price) relating to ESOs exercised by petitioner's employees (spread theory). Respondent defined the spread as the amount of petitioners' section 83 deduction relating to the exercise of NSOs and disqualifying dispositions of ISOs and ESPP purchase rights. [10] Respondent's determination resulted in the following deficiencies and penalties: [11]

		Penalty
Year	Deficiency	Sec. 6662(a)
1996	$24,653,660	$4,935,813
1997	25,930,531	5,189,389
1998	27,857,516	5,573,412
1999	27,243,975	5,448,795

[**20]

10 ISOs and ESPP purchase rights meeting the requirements of secs. 422 and 423, however, were not included in respondent's definition because they are not subject to tax under sec. 83 (see supra note 5).

11 Respondent's reallocation of petitioner's expenses, in turn, reduced petitioner's deductible business expenses and increased petitioner's taxable income.

On March 26, 2001, and January 14, 2003, respectively, petitioners timely filed their petitions with the Court seeking a redetermination of the deficiencies set forth in the December 28, 2000, and October 17, 2002, notices. Petitioner's principal place of business was San Jose, California, at the time the petitions were filed. On April 4, 2002, the [**21] parties stipulated that no amount relating to ESOs would be included in petitioner's 1996 cost-sharing pool.

B. Summary Judgment Motions

The Court filed petitioners' motion for partial summary judgment on February 4, 2002, and on March 6, 2002, filed respondent's cross-motion for partial summary judgment. On October 28, 2003, we denied both parties' motions, addressed [*48] whether the spread is a cost pursuant to section 1.482-7(d)(1), Income Tax Regs., and concluded:

> respondent has not established that the spread is indeed a cost or that the exercise date is the appropriate time to determine and measure such cost. * * * In addition, * * * petitioner has not sufficiently established that it did not incur an expense upon the employee's exercise of the options at issue.

The Court also addressed whether respondent's lack of knowledge of comparable transactions (i.e., where unrelated parties agree to share the spread), or a finding that uncontrolled parties would not share the spread, would have any effect on respondent's authority to make allocations pursuant to section 1.482-1(a)(2), Income Tax Regs. [**22] We concluded:

> Section 1.482-1(b)(2), Income Tax Regs., does not require respondent to have actual knowledge of an arm's-length transaction as a prerequisite to determining that an allocation should be made. See Seagate Technology, Inc. v. Commissioner, T.C. Memo. 2000-388. If, however, it is established that uncontrolled parties would not share the spread, we may conclude that respondent's determination is arbitrary, capricious, or unreasonable. * * * neither party has presented sufficient evidence or established facts adequately addressing whether the arm's-length standard has been met.

C. Promulgation of Regulations Addressing Cost Sharing of Stock-Based Compensation

On July 29, 2002, the U.S. Department of the Treasury (Treasury) issued proposed regulations regarding the treatment of ESOs for cost-sharing purposes. In the preamble accompanying these proposed regulations, Treasury stated:

> The proposed regulations provide that in determining a controlled participant's operating expenses within the meaning of section 1.482-7(d)(1), [**23] all compensation, including stock-based compensation, * * * must be taken into account.

67 Fed. Reg. 48999 (July 29, 2002). As a result of this change (i.e., the inclusion of stock-based compensation) to section 1.482-7(d)(1), Income Tax Regs., Treasury stated that it was adding:

> express provisions coordinating the cost sharing rules of section 1.482-7 with the

arm's length standard as set forth in section 1.482-1. New section 1.482-7(a)(3) clarifies that in order for a qualified cost sharing arrangement to produce results consistent with an arm's length result within the meaning of section 1.482- 1(b)(1), all requirements of section 1.482-7 must be met, including the requirement that each controlled participant's share of intangible development [*49] costs equal its share of reasonably anticipated benefits attributable to the development of intangibles. The proposed regulations also make amendments to section 1.482-1 to clarify that section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement [**24] produces results consistent with an arm's length result, and to clarify that under the best method rule, the provisions of section 1.482-7 set forth the applicable method with respect to qualified cost sharing arrangements.

Id. at 49000. Sections 1.482-1 and 1.482-7, Income Tax Regs., were modified as follows:

SEC. 1.482-1. Allocation of Income and Deductions Among Taxpayers.

* * * * * * *

(2) * * * Section 1.482-7 provides the specific method to be

used to evaluate whether a qualified cost sharing arrangement

produces results consistent with an arm's length result.

* * * * * * *

SEC. 1.482-7. Sharing of Costs.

* * * * * * *

(3) Coordination with section 1.482-1.--A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of section 1.482-1(b)(1) if, and only if, each controlled [**25] participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

* * * * * * *

(2) Stock-based compensation. -- (i) * * * a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. * * * stock-based compensation means any compensation provided by a controlled participant to an employee * * * in the form of equity instruments, options to acquire stock

(stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or [**26] other property.

(ii) * * * all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles * * * is included as an intangible development cost * * *.

(iii) Measurement and timing of stock-based compensation expense. -- (A) In general. -- Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal [*50] income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(1) Transfers to which section 421 applies. -- Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

Id. at 49001. On August 26, 2003, Treasury [**27] finalized its proposed regulations without modifying the above-referenced provisions. The final regulations are applicable to stock-based compensation provided to employees in taxable years beginning on or after August 26, 2003.

D. Respondent's Amendments to Answer

In the December 28, 2000, notice of deficiency, respondent determined that the cost-sharing pool included ESOs granted to petitioner's research and development employees prior to and after April 2, 1995 (i.e., the cost-sharing agreement's execution date), and exercised during 1997 and 1998. On August 4, 2003, the Court filed respondent's motion for leave to file an amendment to the answer in docket No. 4142-01 (i.e., relating to 1997 and 1998). On October 21, 2003, the Court granted the motion and filed respondent's amendment to answer which asserted that the only ESOs at issue were those granted on or after April 2, 1995, and exercised during 1997 and 1998. As a result of this amendment, respondent's adjustments to petitioner's cost-sharing pool, relating to ESOs exercised in 1997 and 1998, decreased from $ 4,504,781 to $ 389,037 and $ 5,195,104 to $ 1,263,006, respectively.

On November 25, 2003, the Court [**28] granted the parties' joint motion to consolidate docket No. 4142-01 and docket No. 702-03 (i.e., relating to 1999) for purposes of trial, briefing, and opinion.

The Court, on February 6, 2004, filed respondent's motion for leave to file a second amendment to the answer in docket No. 4142-01 and an amendment to the amended answer in docket No. 702-03. In this motion, respondent sought permission to contend that ESOs provided to petitioner's research and development employees be valued as of the date those options were granted (grant date theory). On April 8, 2004, [*51] the Court denied respondent's motion because the motion failed to provide sufficient information (i.e., the number of options at issue or the amounts of the revised deficiencies) relating to respondent's grant date theory.

The Court, on May 11, 2004, filed respondent's motion for leave to file a second amendment to the answer in docket No. 4142-01 and an amendment to the amended answer in docket No. 702-03. In this motion, respondent included the number of options at issue and the amounts of the revised deficiencies. Pursuant to his grant date theory, the amounts of the revised deficiencies relating to 1997, 1998, and 1999 [**29] are $ 25,121,951, $ 27,854,698, and $ 24,784,465, respectively. On June 3, 2004, the Court granted respondent's motion but concluded that respondent's amendment raised a new matter because "the grant date theory requires different evidence (i.e., includes additional options and utilizes a different method of valuation)" and alters the original deficiency. On July 14, 2004, the trial commenced.

Discussion

I. Applicable Statute and Regulations

A. Purpose and Scope of Section 482

Section 482 was enacted to prevent tax evasion and ensure that taxpayers clearly reflect income relating to transactions between controlled entities. It accomplishes this purpose by authorizing respondent:

> [to] distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among * * * [controlled entities], if he determines that such distribution, apportionment, or allocation is necessary * * * to prevent evasion of taxes or clearly to reflect the income of * * * [such entities].

Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer [**30] by determining the true taxable income of the controlled taxpayer. Sec. 1.482-1(a)(1), Income Tax Regs. In determining true taxable income, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." See United States Steel Corp. v. Commissioner, 617 F.2d 942, 947 (2d Cir. 1980) (stating the "'arm's length' standard is * * * meant to be an objective standard that does not depend on [*52] the absence or presence of any intent on the part of the taxpayer to distort his income."), revg. T.C. Memo. 1977-140; sec. 1.482-1(b)(1), Income Tax Regs. Because identical transactions are rare, the arm's-length result will "generally * * * be determined by reference to the results of comparable transactions under comparable circumstances." Sec. 1.482-1(b)(1), Income Tax Regs.

B. Application of Section 482 to Qualified Cost-Sharing Agreements

Section 482 provides that "In the case of any transfer * * * of intangible property * * * the income with respect to such transfer * * * shall be commensurate with the income attributable [**31] to the intangible." Participants in a qualified cost-sharing agreement (QCSA) relinquish exclusive ownership of all exploitation rights in new intangibles they individually develop and agree to share ownership of, and costs associated with, such intangibles. For purposes of section 482, this relinquishment constitutes a transfer of specified future exploitation rights. See sec. 1.482-7(a)(3), (g), Income Tax Regs.

Section 1.482-7(a)(1), Income Tax Regs., requires participants "to share the costs of development of one or more intangibles in proportion to their * * * [respective] shares of reasonably anticipated benefits." Anticipated benefits are defined as "additional income generated or costs saved by the use of covered intangibles". Sec. 1.482-7(e)(1), Income Tax Regs. If parties fail to share such costs in proportion with their benefits, respondent is authorized to make allocations "to the extent necessary to make each controlled participant's share of the costs * * * equal to its share of reasonably anticipated benefits". Sec. 1.482-7(a)(2), Income Tax Regs.

II. Are the Spread and Grant Date Value [**32] Costs for Purposes of Section 1.482-7, Income Tax Regs.

Intangible development costs are defined as "all of the costs incurred * * * related to the intangible development area * * * [which] consist of the following items: operating expenses as defined in * * * [section] 1.482-5(d)(3), other than depreciation or amortization expense". Sec. 1.482-7(d)(1), Income Tax Regs. Operating expenses are defined as [*53] "all expenses not included in cost of goods sold except for interest expense, foreign income taxes * * *, domestic income taxes, and any other expenses not related to the operation of the relevant business activity." Sec. 1.482-5(d)(3), Income Tax Regs.

Respondent contends that petitioner paid its employees ESOs in exchange for research and development services, and such services contributed to petitioner's development of intangibles. In support of his position, respondent emphasizes petitioners' tax treatment of options for section 41, Credit For Increasing Research Activities, and section 83 purposes.

Petitioners contend that there was no outlay of cash upon the issuance of its ESOs, and thus, no [**33] cost was incurred. Petitioners further contend that any cost associated with the ESOs was borne by shareholders because the exercise of ESOs increased the outstanding shares and reduced existing shareholders' earnings per share. In addition, petitioners contend that the costs determined by respondent are not related to petitioner's intangible development area. Assuming arguendo that the spread and the grant date value are costs for purposes of section 1.482-7(d), Income Tax Regs., we conclude that respondent's allocations fail to meet the requirements of section 1.482-1(b), Income Tax Regs. (discussed infra section III. D).

III. Respondent's Allocations Are Inconsistent With the Arm's-Length Standard Mandated by Section 1.482-1, Income Tax Regs. A. Respondent's Authority To Make Allocations

Section 482 provides respondent with wide latitude in allocating income and deductions between controlled parties to ensure such parties report their true taxable income. This broad grant of authority, however, is constrained by section 1.482-1, Income Tax Regs., which sets forth [**34] the "general principles and guidelines to be followed under section 482." Sec. 1.482-1(a)(1), Income Tax Regs. The sections to which these general principles and guidelines apply include, but are not limited to, section 1.482-7, Income Tax Regs. Id.

Section 1.482-1(a)(2), Income Tax Regs., authorizes respondent to "make allocations between or among the members [*54] of a controlled group if a controlled taxpayer has not reported its true taxable income." In determining true taxable income, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer" (i.e., arm's-length standard). Sec. 1.482-1(b)(1), Income Tax Regs. (emphasis added). The arm's-length standard is employed to ensure that related party transactions clearly reflect the income of each party and to prevent tax evasion.

B. Respondent's Interpretation of Sections 1.482-1 and 1.482-7 , Income Tax Regs., Is Incorrect

Neither party disputes the absence of comparable transactions in which unrelated parties agree to share the spread or the grant date [**35] value. Nor do the parties dispute the fact that unrelated parties would not "explicitly" (i.e., within the written terms of their agreements) share the spread or the grant date value. The parties, however, disagree about what effect these facts have on respondent's authority to make allocations pursuant to section 1.482-1, Income Tax Regs.

Pursuant to section 1.482-1(b)(1), Income Tax Regs., "A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances". Section 1.482-1(b)(1), Income Tax Regs., further states:

> because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. [Emphasis added.]

Respondent presented no evidence or testimony establishing that his determinations are arm's length. He simply contends that the "application [**36] of the express terms of Treas. Reg. section 1.482-7 itself produces an arm's-length result," and that "it is unnecessary to perform any type of comparability analysis to determine * * * whether parties at arm's length would share * * * [the spread or the grant date value]". Thus, respondent contends that the spread and the grant date value amounts he determined automatically meet the arm's-length standard. In support of his contention, respondent [*55] focuses on the meaning of the term "generally" in section 1.482-1(b)(1), Income Tax Regs. He asserts:

A rule that applies only "generally" must, by its own terms, have exceptions. In light of the legislative history and extensive regulations interpreting the 1986 commensurate with income statutory amendment, qualified cost sharing arrangements constitute an appropriate exception from the general rule.

According to respondent, "the identification of costs, and the corresponding adjustments to the cost pool under qualified cost-sharing arrangements, should be determined without regard to the existence of uncontrolled transactions." We disagree.

[**37] Respondent's interpretation of the word "generally" is incorrect because he ignores the preceding clause (i.e., "because identical transactions can rarely be located"). The regulation simply states that "comparable transactions" are the broad exception available when there are no identical transactions. See Union Carbide Corp. & Subs. v. Commissioner, 110 T.C. 375, 384

(1998) (stating "When the plain language of the statute or regulation is clear and unambiguous, * * * the inquiry * * * [ends]."). The regulation does not state that any allocation proposed by respondent automatically produces an arm's-length result without reference to what arm's-length parties would do. Therefore, respondent's litigating position is contrary to his regulations. See Phillips v. Commissioner, 88 T.C. 529, 534 (1987) (stating respondent "may not choose to litigate against the officially published rulings * * * without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law"), affd. 271 U.S. App. D.C. 265, 851 F.2d 1492 (D.C. Cir. 1988). Pursuant to the express language of section 1.482-1(a)(1), Income Tax Regs. [**38] , we conclude that the arm's-length standard is applicable in determining the appropriate allocation of costs pursuant to section 1.482-7, Income Tax Regs. C. Legislative and Regulatory History Support the

Applicability of the Arm's-Length Standard to Section 1.482-7,

Income Tax Regs.

Respondent contends that the legislative and regulatory history relating to the 1986 amendment to section 482 establishes that, for purposes of determining the arm's-length result in cost-sharing arrangements, Congress intended to [*56] supplant the use of comparable transactions with internal measures of cost and profit.

It is unnecessary and inappropriate to resort to legislative, and certainly not to regulatory, history, because section 1.482-1(b)(1), Income Tax Regs., is unambiguous. Union Carbide Corp. & Subs. v. Commissioner, supra at 384. Even if the regulations were ambiguous, our conclusion would not change because the legislative and regulatory history relating to section 482 supports our holding that the arm's-length standard is applicable in determining the appropriate allocation of costs pursuant to section 1.482-7, Income Tax Regs. [**39]

In 1986, Congress amended section 482 by adding "In the case of any transfer * * * of intangible property * * * the income with respect to such transfer * * * shall be commensurate with the income attributable to the intangible." This change reflected a concern that the statute had failed to effectively prevent transfer pricing abuses in controlled transactions (e.g., companies transferring intangibles to related foreign companies in exchange for a "relatively low royalty [rate]" based on "industry norms for transfers of less profitable intangibles."). H. Rept. 99-426, at 424 (1985), 1986-3 C.B. (Vol. 2) 424; accord Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 1014-1015 (J. Comm. Print 1987); see H. Rept. 99-426, supra at 424-425, 1986-3 C.B. (Vol. 2) 424-425. The committee stated:

> In making this change, Congress intended to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor payment for related party intangibles transfers.

H. Rept. 99-426, at 414 (1985), 1986-23 C.B. (Vol. 2) 424. The committee concluded: "it is appropriate to [**40] require that the payment made on a transfer of intangibles to a related foreign corporation * * * be commensurate with the income attributable to the intangible." H. Rept. 99-426 at 414 (1985), 1986-23 C.B. (Vol. 2) 424.

Respondent contends that the regulatory history, including Treasury's publication of Notice 88-123, 1988-2 C.B. 458 (the White Paper), establishes that the commensurate with income standard replaced the arm's-length standard mandated in section 1.482-1, Income Tax Regs. We note that regulatory history, like legislative history, is a far less [*57] accurate embodiment of intent than plain language and is susceptible to a wide array of interpretations. Nevertheless, our conclusion is consistent with the White Paper and the 1992 and 1995 regulations. Contrary to respondent's contentions, the commensurate with income standard was intended to supplement and support, not supplant, the arm's-length standard. Nothing in section 482, its accompanying regulations, or its legislative history indicates that internal measures of cost and profit should be used to the exclusion of the arm's-length standard.

The White Paper reexamined [**41] the theory and administration of section 482 and concluded:

> Looking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do. The general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible.

Notice 88-123, 1988-2 C.B. 458, 472. In 1992, respondent promulgated regulations, interpreting section 482, which were finalized in 1995. Neither the 1992 nor 1995 regulations contain language indicating any intention to remove the arm's-length standard with respect to cost-sharing determinations or prevent consideration of uncontrolled transactions. In fact, the preamble to the 1992 proposed regulations states that section 1.482-1(b)(1), Income Tax Regs., "clarifies the general meaning of the arm's length standard * * * [as] whether uncontrolled taxpayers exercising sound business judgment would have agreed to the same terms given the actual circumstances [**42] under which controlled taxpayers dealt." See DHL Corp. v. Comm'r, 285 F.3d 1210, 1222 (9th Cir. 2002) (relying on the preamble to interpret section 1.482-2(d), Income Tax Regs.); Armco, Inc. v. Commissioner, 87 T.C. 865, 868 (1986) (stating "A preamble will frequently express the intended effect of some part of a regulation * * * [and] might be helpful in interpreting an ambiguity in a regulation."); Proposed Income Tax Regs., 57 Fed. Reg. 3571 (Jan. 30, 1992).

Finally, respondent contends that the general rules of statutory interpretation require us to construe the regulations [*58] in a manner that "avoids conflict within the regulatory scheme, and harmonizes with the underlying * * * [statute's]" purpose. The Court, however, will not ignore the regulations' explicit terms in order to accommodate respondent's litigating position. While Treasury has the authority to modify its regulations to resolve any conflict within the regulatory scheme, we must "apply the provisions of respondent's regulations as we find them and not as we think they might or ought to have been written." Larson v. Commissioner, 66 T.C. 159, 186 (1976). [**43] The arm's-length standard is included without exception, and the 1986 modification of section 482 did not eliminate the use of comparable transactions in determining a controlled taxpayer's income. Section 1.482-1, Income Tax Regs., explicitly provides that the arm's-length standard applies to "all transactions". Cost-sharing determinations pursuant to section 1.482-7, Income Tax Regs., are not exempted. Accordingly, if unrelated parties would not share the spread or the grant date value, respondent's determinations are arbitrary and capricious.

D. Unrelated Parties Would Not Share the Spread or Grant Date

Value

Respondent contends that unrelated parties "implicitly" share the spread [12] and the grant date value, [13] but both parties agree that unrelated parties would not explicitly share these amounts. Indeed, Scott T. Newlon, the only witness proffered by respondent to address this issue, testified that parties "don't * * * explicitly [share any amount for ESOs] because * * * it would be hard for the parties to agree on a measurement * * * and it may * * * [leave them] open to * * * potential disputes." [**44] These considerations are aptly summarized by Irving Plotkin, one of petitioners' experts, who testified:

> In the real world, these measures [the spread and grant date value] are so speculative and controversial, and the link between them and the value of R&D functions performed by the ESO holder is so tenuous, that unrelated [*59] parties in joint research arrangement simply do not agree to pay any amount for ESOs granted to the employees of an entity providing R&D services.

12 As a result of respondent's Oct. 21, 2003, amendment to answer, the parties dispute who has the burden of proof with respect to the spread theory. Our conclusion is based on the preponderance of the evidence. Thus, the burden of proof is immaterial. See Martin Ice Cream Co. v. Commissioner, 110 T.C. 189, 210 n. 16 (1998).

13 Because we determined, in our June 3, 2004, order, that the grant date theory is a new matter, respondent bears the burden of proof with respect to this theory. Rule 142(a); Shea v. Commissioner, 112 T.C. 183 (1999).

[**45] Petitioners also established that, for product pricing purposes, companies (i.e., those who enter into cost-sharing arrangements relating to intangibles) do not take into account the spread or the grant date value relating to ESOs.

While respondent concedes that unrelated parties do not explicitly share costs attributable to ESOs, he contends that unrelated parties "negotiate terms that implicitly compensate * * * [development] costs not directly shared or reimbursed." (Emphasis added.) Respondent, however, did not present any credible evidence that unrelated parties implicitly share the spread or grant date value related to ESOs. Scott T. Newlon, the only witness respondent proffered to address this issue, did not reference any other economists, unpublished or published articles, or any transactions supporting his theory. In fact, he conceded that it was not possible to test whether parties implicitly include ESOs as a compensation cost in cost-sharing agreements. Petitioners, however, through the testimony of numerous credible witnesses, established that companies do not implicitly take into account the spread or the grant date value for purposes of determining costs relating [**46] to cost-sharing agreements. Furthermore, petitioners established that if unrelated parties believed that the spread and grant date value were costs related to intangible development activities, such parties would be very explicit about their treatment for purposes of their agreements. In short, respondent's implicit cost theory is specious and unsupported.

1. The Spread

Unrelated parties would not share the spread because it is difficult to estimate, unpredictable, and potentially large in amount. Petitioners' uncontradicted evidence established that certainty and control are of paramount importance to unrelated parties involved in cost-sharing arrangements. Yet, the size of the spread is affected by a variety of factors, many of which are not within the control of the contracting parties. More specifically, the size of the spread is based on the exercise price and the stock price on the exercise date. It is [*60] indisputable that changes in stock prices are frequent and unpredictable, and that a wide variety of external factors may influence such prices. In fact, the entire market, or stock in individual companies, may move up or down based on market and industry trends [**47] and a myriad of factors including, but not limited to, inflation, interest and unemployment rates, consumer demand, energy prices, programmed trading, etc. As a result, petitioner's stock price may move in response to such trends and be affected by these factors. For example, respondent concedes that he does not know whether the rises in petitioner's stock price were attributable to increases in the market as a whole or the semiconductor industry in particular.

Stock prices are also sometimes affected by investor trading based on erroneous information. In such cases, a temporary change in stock price may be based on transient misperceptions of value among investors.

The spread is also significantly affected by an employee's investment decision regarding when to exercise the option. Indeed, the timing of the ESO-holder's decision to exercise the ESO may have a dramatic impact on the size of the spread. While the exercise price is fixed at the grant date, the value of the stock is not fixed until the ESO-holder exercises the option. This personal decision is based on the employee's liquidity needs, aversion to risks, and other miscellaneous factors. In essence, the market and ESO-holder, [**48] rather than the contracting parties, determine the size of the spread and when the spread will be incurred. Simply put, rational profit-maximizing unrelated parties would not cede this control over costs or be willing to accept such a high degree of uncertainty relating to costs.

In short, the value of petitioner's stock, and thus the potential size of the spread relating to ESOs, could rise and fall in line with the vicissitudes and vagaries of the market. The semiconductor industry, of which petitioner is a prominent member, may be particularly subject to these types of market swings and trends. Thus, the spread is affected by a myriad of factors and calculated and incurred at a point in time when the contracting parties have no control over the amount.

[*61] Finally, we note that sharing the spread could also create perverse incentives for unrelated parties. One of petitioners' experts, Mukesh Bajaj, stated:

> A well-designed economic contract would ensure that both partners have an incentive in seeing the value of the other partner rise. If * * * the Spread * * * has to be cost-shared, the cost sharing partner has a perverse incentive to diminish [**49] (or at least help contain) the

stock price of the other firm because the lower this price, the less the spread-based cost that the partner has to bear.

Unrelated parties would not be inclined to enter into a contract which contains terms that could encourage such counterproductive conduct. Accordingly, respondent's allocation relating to the spread theory fails to meet the arm's-length standard mandated by section 1.482-1(b), Income Tax Regs. [14]

14 Petitioners' treatment of the spread as a reimbursable expense for purposes of its intercompany agreement with XI has no bearing on our conclusion. Sec. 482 looks to transactions between unrelated, not related, parties to determine whether the arm's-length standard in sec. 1.482-1, Income Tax Regs., has been satisfied.

2. Grant Date Value

Respondent, who had the burden of proof with respect to the grant date theory, presented no evidence that unrelated parties would, pursuant [**50] to the FVM, make a cost-sharing allocation of at-the-money options or ESPP purchase rights. To the contrary, petitioners' uncontradicted evidence established that in determining cost allocations unrelated parties would not include any cost related to the issuance of ESOs. In essence, respondent contends that petitioner was required to allocate, and thereby sustain tangible economic consequences relating to, an amount that unrelated parties do not treat as an expense for tax or financial accounting purposes. [15] Accordingly, respondent's allocation relating to the grant date value fails to meet the arm's-length standard mandated by section 1.482-1(b), Income Tax Regs.

15 ESOs generally do not have an ascertainable fair market value on the grant date for purposes of sec. 1.83-7(b)(3), Income Tax Regs. Thus, the grant date value is not a tax expense pursuant to sec. 83. During the years in issue, most companies used the IVM, and thus, were not required, for financial accounting purposes, to record an expense relating to options issued at-the-money and certain ESPP purchase rights.

[**51] During the years in issue, petitioners employed the IVM, which did not treat at-the-money options as expenses. From 1972 until December 15, 1995, the IVM was the only financial [*62] accounting method authorized by FASB for measuring and reporting the value of options, and thus, the only available method during the first year of petitioner's cost-sharing agreement. Thereafter, the FVM was the preferred method, yet petitioners were under no affirmative obligation to elect the FVM. [16] In addition, during the years in issue most companies used the IVM for purposes of valuing ESOs. [17] Thus, consistent with the parties' expert testimony, unrelated parties would treat ESOs in a manner consistent with the IVM, rather than the FVM. [18] Accordingly, petitioners' allocation relating to its ESOs satisfies the arm's-length standard in section 1.482-1(b), Income Tax Regs.

16 In 1996, petitioner employed the IVM to calculate ESO costs. Respondent, in his Dec. 28, 2000, notice of deficiency, determined that petitioner's 1996 cost-sharing pool should be increased by $ 14,939,494 relating to stock options and ESPP purchase rights. The parties subsequently stipulated that this amount would not be included in the 1996 cost-sharing pool.

[**52]

17 Although the IVM has been criticized for not measuring the call premium of an ESO, both parties' experts acknowledged that an ESO's call premium may have some value but cast doubt on whether it could be reliably measured.

18 The parties stipulated that "Immediately after SFAS 123 became effective, the vast majority of public companies chose to continue to follow the intrinsic value method of APB 25." No evidence, however, was presented concerning the companies who used the FVM.

IV. Section 6662(a) Penalty

Section 6662(a) imposes a 20-percent accuracy-related penalty on the portion of an underpayment of tax which is attributable to a taxpayer's negligence or disregard of rules or regulations. Sec. 6662(b)(1). Because we reject respondent's determinations, petitioners are not liable for section 6662(a) penalties.

V. Conclusion

The express language in section 1.482-1(a)(1), Income Tax Regs., establishes that the arm's-length standard applies to section 1.482-7, Income Tax Regs., for purposes of determining appropriate cost allocations. [**53] Because unrelated parties would not share the spread or the grant date value, respondent's imposition of such a requirement is inconsistent with section 1.482-1, Income Tax Regs. Simply put, the regulations applicable to the years in issue did not authorize respondent to require taxpayers to share the spread or the grant date value relating to ESOs. Petitioners are merely required to be compliant, not prescient. Accordingly, we hold that respondent's allocations are arbitrary and capricious; [*63] petitioners' allocations meet the arm's-length standard mandated by section 1.482-1, Income Tax Regs.; and petitioners are not liable for the section 6662(a) penalties.

Contentions we have not addressed are irrelevant, moot, or meritless.

To reflect the foregoing and concessions made by the parties,

Decisions will be entered under Rule 155.

ADDENDUM C

TREATY ARTICLE EXCERPTS:

1949 U.S.-Ireland Tax Treaty

ARTICLE I:

(1) The taxes which are the subject of the present Convention are:

(a) In the United States of America:

The Federal income taxes, including surtaxes (hereinafter referred to as United States tax).

(b) In Ireland:

The income tax (including surtax) and the corporation profits tax (hereinafter referred to as Irish tax).

(2) The present convention shall also apply to any other taxes of a substantially similar character imposed by either Contracting Party subsequently to the date of signature of the present Convention.

ARTICLE II:

(1) In the present Convention, unless the context otherwise requires--

....

(k) The terms “enterprise of one of the Contracting Parties” and “enterprise of the other Contracting Party” means a United States enterprise or an Irish enterprise, as the context requires.

ARTICLE IV:

Where an enterprise of one of the Contracting Parties, by reason of its participation in the management, control or capital of an enterprise of the other Contracting

Party, makes with or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which would normally have accrued to one of the enterprises but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

<u>1997 U.S.-Ireland Tax Treaty</u>

ARTICLE 1:

General Scope

....

4. Notwithstanding any provision of the Convention, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

5. The provisions of paragraph 4 shall not affect:

a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraph 2 of Article 16 (Directors' Fees), paragraphs 1(b) and 4 of Article 18 (Pensions, Social Security, Annuities, Alimony and Child Support), and Articles 24 (Relief From Double Taxation), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure); and

b) the benefits conferred by a Contracting State under paragraph 5 of Article 18 (Pensions, Social Security, Annuities, Alimony and Child Support), Articles 19 (Government Service), 20 (Students and Trainees) and 28 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.

ARTICLE 9:

Associated Enterprises

1. Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then, any profits that, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the other Contracting State agrees that the profits so included are profits that would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those that would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits in determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

ARTICLE 26:

Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States and the time limits prescribed in such laws for presenting claims for refund, present his case to the competent authority of either Contracting State.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree, with a view to the avoidance of taxation which is not in accordance with the Convention:

a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

b) to the same allocation of income, deductions, credits, or allowances between persons;

c) to the same characterization of particular items of income;

d) to the same characterization of persons;

e) to the same application of source rules with respect to particular items of income;

f) to a common meaning of a term;

g) to increases in any specific dollar amounts referred to in the Convention to reflect economic or monetary developments;

h) to advance pricing arrangements; and

i) to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the Convention.

They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

Any principle of general application established by an agreement or agreements shall be published by the competent authorities of both Contracting States in accordance with their laws and administrative practices.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. If an agreement cannot be reached by the competent authorities pursuant to the previous paragraphs of this article, the case may, if both competent authorities and the taxpayer agree, be submitted for arbitration, provided that the taxpayer agrees in writing to be bound by the decision of the arbitration board. The competent authorities may release to the arbitration board such information as is necessary for carrying out the arbitration procedure. The decision of the arbitration board shall be binding on the taxpayer and on both States with regard to that case. The procedures, including the composition of the board, shall be established between the Contracting States by notes to be exchanged through diplomatic channels after consultation between the competent authorities. The provisions of this paragraph shall not have effect until the date specified in the exchange of diplomatic notes.

ADDENDUM D

Revenue

www.revenue.ie

Office of the Revenue Commissioners
Corporate Business and
International Division
Dublin Castle
Dublin 2, Ireland

Oifig na gCoimisinéirí Ioncaim
Rannán Gnó Corparáidigh agus
Idirnáisiúnta
Caisleán Bhaile Átha Cliath
Baile Átha Cliath 2, Éire

Mr John McGurrin,
International Tax Director,
Xilinx Ireland,
Citywest Business Campus,
Saggart,
Co. Dublin.

29 July 2009

Re: Decision of the United States Court of Appeals for the Ninth Circuit in the case of Xilinx Inc., and Consolidated Subsidiaries v. Commissioner of Internal Revenue

Dear Mr. McGurrin

Revenue has written to the United States Competent Authorities, in accordance with Article 26 (Mutual Agreement Procedure) of the Ireland/ United States of America Double Taxation Convention, in relation to the decision of the United States Court of Appeals (Ninth Circuit).

Revenue's letter conveyed that, in the event that the decision became final, Revenue would then wish to consult with the United States Competent Authorities because it was not clear how, consistent with the decision, double taxation could be avoided.

Yours faithfully

Eamonn O'Dea

Eamonn O'Dea
Assistant Secretary

Telephone: +353-1-6748390 Email: eodea@revenue.ie

ADDENDUM E

August 11, 2009

Ms. Molly Dwyer
Clerk of the Court
Office of the Clerk
U.S. Court of Appeals for the Ninth Circuit
P.O. Box 193939
San Francisco, CA 94119-3939

Re: ***Xilinx, Inc. and Consolidated Subsidiaries v. Commissioner of Internal Revenue*** **(Nos. 06-74246, 06-74269)**

Dear Ms. Dwyer:

We are writing, as former senior tax officials of a number of U.S. trading partners, to express concern regarding the Ninth Circuit panel majority decision in *Xilinx, Inc. v. Commissioner* (May 27, 2009), which raises issues of importance regarding the interplay of U.S. domestic transfer pricing law and U.S. international tax policy, with potentially serious implications for the international consensus reflected in the global network of tax treaties concluded by the U.S. and its trading partners to avoid double taxation in order to facilitate global trade and investment.

While some of us are currently affiliated with firms that may have relationships with other entities that have some interest in the outcome of this case, none of us has a relationship with the parties to this case. We are signing not on behalf of our current or former employers but in our individual capacities, because we are knowledgeable about the issue involved and are concerned about it from a professional standpoint. A summary of our respective relevant government experiences is attached for information. We respectfully ask that you distribute this letter to all Judges on the Court.

As former tax officials of our respective countries, each of us was responsible for the negotiation, application, and/or interpretation of our country's tax treaty with the United States. Transfer pricing rules are among the most important provisions of a treaty, so many of us regularly discussed transfer pricing issues with our U.S. counterparts in negotiating or implementing the provisions of our respective treaties, in concluding agreements to apply the arm's length standard in particular cases, or in developing international transfer pricing policy and guidance at the Organisation for Economic Co-operation and Development (OECD).

The United States has always advocated use of the arm's length standard for transfer pricing, both in U.S. domestic law and U.S. treaties and as the international norm. U.S. officials have consistently taken the view that U.S. transfer pricing regulations were required to be, and were in fact, consistent with the arm's length standard, as defined internationally in tax treaties and OECD guidance. In our experience, there has never been any indication that the "saving clause" or any other treaty provision would be applied to permit the United States to depart from the arm's length standard.

Although both the IRS and the taxpayer advocated application of the arm's length standard in the *Xilinx* case, the panel majority's rationale—that a more specific Treasury cost sharing regulation prevailed over a general regulation mandating that the arm's length standard govern "in every case"—is contrary to the international norm requiring application of the arm's length standard. The panel majority's opinion further suggests that U.S. tax treaties permit the United States to adopt and apply regulations that do not satisfy the international arm's length standard. This result would be inconsistent with the basis on which the United States historically has negotiated and implemented its tax treaties and with the longstanding policy and practice of the United States and other OECD member countries.

The panel majority's decision thus injects profound uncertainty regarding the U.S. taxation of an important component of the international economy, related-party business transactions. We are writing because the decision will create confusion not only for U.S. transfer pricing and U.S. business, but for transfer pricing in other countries as well. It also calls into question the ability of the United States to honor its international tax treaty obligations, which may prompt other countries to follow suit and significantly increase the risk of double taxation. It is unclear from the panel majority's discussion whether the panel majority considered or understood these broader international and policy aspects of its decision. For these reasons we urge the Ninth Circuit panel to grant a rehearing, or, failing that, for the Court to rehear the case *en banc*.

Respectfully submitted,

Digeronimo

Angelo Digeronimo
Counsel, Python & Peter, Berne, Switzerland
Formerly Corporate Tax Expert, International Division, Federal Tax Administration, Ministry of Finance, Switzerland

Bruno Gibert
Attorney at Law and Partner, CMS Bureau Francis Lefèbvre, Paris, France
Chair, European Union Joint Transfer Pricing Forum
Formerly Director, International Division, Tax Policy Department, and Competent Authority for Mutual Agreement Procedures, Ministry of Finance, France; Co-Chair of the OECD Forum on Harmful Tax Competition

David Grecian

David Grecian
National Director, Competent Authority Services, Deloitte Touche Tohmatsu Ltd, Melbourne, Australia
Formerly Senior Assistant Commissioner, International Strategy & Operations; Assistant Commissioner, International Tax Division, Australian Taxation Office; Chair, Working Party No. 6 of the Committee on Fiscal Affairs, OECD

Diane Hay

Diane Hay
Special Advisor to PricewaterhouseCoopers LLP, London, England
Formerly Deputy Director CT&VAT and U.K. Competent Authority, HM Revenue & Customs; Assistant Director, International Division, and U.K. Competent Authority, Inland Revenue

F. Jacob

Friedhelm Jacob
Partner, Hengeler Mueller, Frankfurt, Germany
Formerly *Regierungsdirektor* [Associate International Tax Counsel], *Bundesministerium der Finanzen* [Federal Ministry of Finance], Bonn, Germany; Counselor (Fiscal), German Embassy, Washington, DC

Daniel Lüthi

Daniel Lüthi
International Tax Consultant, Lüthi Consulting, Berne, Switzerland
Formerly Vice Director of the Federal Tax Administration, Ministry of Finance, Switzerland; Delegate of the Swiss Ministry of Finance for International Tax Matters; Chairman of Working Party No. 1 of the Committee on Fiscal Affairs, OECD

Yoshiyasu Okada
Advisor, Zeirishi-Hojin PricewaterhouseCoopers, Tokyo, Japan
Formerly Deputy Commissioner (International) and Japanese Competent Authority, Director of the Office of International Operations, and Director of International Tax Examinations, National Tax Agency, Japan

Karina Pérez Delgadillo—
Global Dispute Resolution Leading Partner, PricewaterhouseCoopers Mexico, Mexico City, Mexico
Formerly Central Administrator for Legal International Tax Issues and Internal Criteria for Large Taxpayers and Mexican Competent Authority, Tax Administration Service; Underdirector General for Treaty Negotiations, Underministry of Revenue, Ministry of Finance and Public Credit, Mexico

Michel Taly—
Partner, Arsène-Taxand, Paris, France
Formerly Head, Tax Policy Department, Ministry of Finance, France; Vice-Chair, Committee on Fiscal Affairs, OECD

Ulrich Wolff
Consultant, *PriceWaterhouseCoopers* Aktiengesellschaft (Germany), Bonn, Germany
Formerly *Referatsleiter* [Head of Division] (International Taxation), Tax Department, and German Competent Authority, *Bundesministerium der Finanzen* [Federal Ministry of Finance], Germany

cc: Arthur T. Catterall, U.S. Department of Justice, Tax Division
Counsel for Appellant

Kenneth B. Clark, Fenwick & West LLP
Counsel for Appellee

Summary of Government Experience of Signatories

Angelo Digeronimo spent 38 years at the Federal Tax Administration of the Ministry of Finance of Switzerland, during which time he held numerous positions including as a Corporate Tax Expert in the International Division. From 1974 to 2008 he served as the Swiss delegate in the discussions and drafting of all OECD reports on transfer pricing. During this time, Mr. Digeronimo was also responsible for Switzerland's Mutual Agreement Procedures and, more recently, Switzerland's Advance Pricing Agreements on transfer pricing disputes.

Bruno Gibert served as the Director of the International Division of the Tax Policy Department at the French Ministry of Finance from 1995 to 2001, where he served as the Competent Authority for Mutual Agreement Procedures and was responsible, *inter alia*, for the negotiation of double tax treaties and the drafting of tax legislation dealing with international issues including transfer pricing. Mr. Gibert also served as representative of France to the Committee on Fiscal Affairs of the OECD and as Co-Chair of the OECD Forum on Harmful Tax Competition from 1996 to 2001 and as representative of France at the European Union for tax matters. During his 16 years with the French Government, Mr. Gibert occupied numerous other positions, including Tax Policy Advisor to then-Minister of Finance Nicolas Sarkozy. Since 2002, Mr. Gibert has served as the Chair of the European Union Joint Forum on Transfer Pricing, which is comprised of one expert from the tax administration of each EU Member State and fifteen experts from business.

David Grecian served, during his thirty-five years at the Australian Taxation Office, as Senior Assistant Commissioner, International Strategy & Operations, as Assistant Commissioner, International Tax Division, and as Competent Authority in both positions, in 1987 and again from 1994-2006. From 2001-2007, Mr. Grecian served as Chair of the OECD Committee on Fiscal Affairs' Working Party No. 6 on Multinational Enterprises, the OECD body responsible for the OECD Transfer Pricing Guidelines and other transfer pricing matters, and as a member of its Steering Group on Transfer Pricing. He also participated as an Australian Delegate to the Working Party's meetings in the 1980s and again beginning in 1998.

Diane Hay served from 2004 to 2008 as the Deputy Director CT&VAT at HM Revenue & Customs, in which capacity she was U.K.'s lead Competent Authority with respect to all transfer pricing issues and had responsibility for the U.K.'s Mutual Agreement Process and its Advance Pricing Programme. During her thirty-one years of government service, Ms. Hay also served, from 1991 to 1994, as the Assistant Director of the International Division at Inland Revenue. In that capacity, she was the U.K.'s Competent Authority with responsibility for the application and interpretation of the U.S.-U.K. tax treaty and was also the U.K.'s lead official on transfer pricing, representing the U.K. at the OECD's Committee on Fiscal Affairs and its Working Group on Multinational Enterprises. Ms. Hay also chaired the first OECD Working Group that revised the 1979 OECD Transfer Pricing Guidelines.

Friedhelm Jacob served as *Regierungsdirektor* [Associate International Tax Counsel] of the German Federal Ministry of Finance from 1980 to 1986. In this capacity he was responsible for the interpretation and application of German tax treaties, including transfer pricing matters. He served as Deputy Chairman of Working Party No. 6 of the OECD Committee on Fiscal Affairs from 1983 to 1986. During his twelve years of government service, Mr. Jacob also served, from 1986 to 1991, as Fiscal Counselor of the German Embassy in Washington, DC, in which capacity he was part of the German delegation that negotiated the 1989 income tax treaty with the United States and acted for the German Competent Authority under the U.S.-Germany tax treaty, with responsibility for the resolution of competent authority procedures, in particular in the transfer pricing area.

Daniel Lüthi has over thirty years of service with the Federal Tax Administration (FTA) of the Ministry of Finance of Switzerland. For eighteen of those years, Mr. Lüthi was the Vice Director of the FTA. In this capacity he was responsible for all international tax matters relating to Switzerland, including the negotiation, application, and interpretation of tax treaties, and the execution of Mutual Agreement Procedures and Advance Pricing Agreements. For thirty-one years, Mr. Lüthi was the Swiss Delegate to OECD Working Party No. 1 on Tax Conventions and Related Issues and to the Committee on Fiscal Affairs. He served as Chairman of Working Party No. 1 for twelve years.

Yoshiyasu Okada joined the Japanese National Tax Agency ("NTA") in 1971 and served in various positions with the NTA over a period of about 25 years, including as the Deputy Commissioner (International), the Director of the Office of International Operations, and the Director of International Tax Examinations. During his tenure as Deputy Commissioner, Mr. Okada served as a member of the Japanese Competent Authority responsible for all international tax matters at the NTA, and as Japan's representative to international meetings, such as the OECD's Committee on Fiscal Affairs. Mr. Okada also served as Vice-Chair of OECD

Working Party No. 6, and played a significant role in advancing the OECD discussion of transfer pricing issues.

Karina Pérez Delgadillo served for seventeen years in the Mexican Government, including for eight years as the Mexican Competent Authority in her role as Central Administrator for Legal International Tax Issues and Internal Criteria for Large Taxpayers, within the General Administration for Large Taxpayers of the Tax Administration Service. In this position, she was in charge of the interpretation and application of Mexican tax treaties, including transfer pricing and other competent authority matters. She also was the delegate for Mexico to the OECD's Committee on Fiscal Affairs. Ms. Pérez Delgadillo previously served as Underdirector General for Treaty Negotiations at the Underministry of Revenue in the Ministry of Finance and Public Credit, where, from 1989 to 1998, she participated in the negotiation of Mexican tax treaties, including its treaty with the United States, and was involved in drafting tax reform proposals concerning international tax matters, including transfer pricing.

Michel Taly served as the Head of the Tax Policy Department at the French Ministry of Finance from 1989 to 1995, where he was responsible for supervising, *inter alia*, the Ministry's negotiation and application of double tax treaties and the drafting of tax legislation, including legislation on transfer pricing and other international issues. During the same years, Mr. Taly also served as the Vice-Chair of the OECD Committee on Fiscal Affairs and was a participant in the discussion of the revised OECD Transfer Pricing Guidelines.

Ulrich Wolff served as a German Government official for 25 years, including, from 1990 to 2005, as a Head of Division (International Taxation) of the Tax Department at the German Federal Ministry of Finance. During the period from 2000 to 2005, Mr. Wolff was responsible for the development of the German Federal Government's transfer pricing rules and policies, and the negotiation, interpretation and application of the tax treaties between Germany and all industrialized countries outside Europe, including the United States. He also served as the German Competent Authority with respect to those treaties. In addition, Mr. Wolff represented the interests of Germany at meetings of the OECD's Committee on Fiscal Affairs and several of its working groups.

CERTIFICATE OF SERVICE

I, Kenneth B. Clark, hereby certify that I electronically filed the foregoing 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:

SEE ATTACHED SERVICE LIST

/s/ Kenneth B. Clark
Kenneth B. Clark
FENWICK & WEST LLP
801 California Street
Mountain View, CA 94041

Attorney for Petitioner-Appellee Xilinx, Inc. and Consolidated Subs.

SERVICE LIST FOR CASE Nos. 06-74246, 06-74269

A. Duane Webber
BAKER & McKENZIE
815 Connecticut Ave., N.W.
Washington, DC 20006

Donald L. Korb
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Eileen J. O'Connor
DOJ - U.S. DEPARTMENT OF JUSTICE
Tax Division/Appellate Section
P.O. Box 502
Washington, DC 20044

John M. Breen
INTERNAL REVENUE SERVICE
1111 Constitution Ave., NW
Washington, DC 20224

Richard T. Morrison
DOJ - U.S. DEPARTMENT OF JUSTICE
Tax Division/Appellate Section
P.O. Box 502
Washington, DC 20044