Nos. 16-70496, 16-70497

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ALTERA CORPORATION & SUBSIDIARIES,

Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

On Appeal from the United States Tax Court

BRIEF OF XILINX, INC. AMICUS CURIAE IN SUPPORT OF ALTERA CORPORATION URGING AFFIRMANCE OF THE TAX COURT DECISION

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CORPORATE DISCLOSURE STATEMENT

In accordance with the Federal Rules of Appellate Procedure 26.1 and 29(c), Xilinx, Inc. hereby states that it has no parent corporation and there is no publicly held corporation that owns 10% or more of its stock.

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INTEREST OF THE AMICUS CURIAE

The Amicus Curiae ("Amicus") is Xilinx, Inc., the world's leading provider of programmable logic devices.[1] Founded in 1983, Xilinx's headquarters are in San Jose, California.

The Tax Court in *Altera* relied on its prior decision in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005). The Commissioner's brief before this Court asserts that the changes made to the cost sharing regulation in 2003 overcome the regulatory deficiencies that the Ninth Circuit determined in its *Xilinx* decision, 598 F.3d 1191 (9th Cir. 2010). Thus, the Commissioner asserts *Xilinx* is not controlling and the 2003 cost sharing regulation is valid.

Xilinx is in a unique position to provide further background and context concerning the *Xilinx* litigation, and how the issues that were presented and decided in *Xilinx*, based on the extensive factual record, are relevant to the validity of the 2003 cost sharing regulation at issue in *Altera*.

INTRODUCTION

The Commissioner's arguments for the validity of the 2003 cost sharing regulation based on the 1986 addition of the commensurate with income sentence to § 482 are the same as the arguments made by the Commissioner in *Xilinx*,

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[1] Counsel for the parties have not authored this brief in whole or in part. No one other than Amicus has contributed money that was intended to fund preparing or submitting this brief.

arguments that both the Tax Court and the Ninth Circuit rejected. Thus, Xilinx believes the Ninth Circuit's *Xilinx* decision has effectively already determined that the 2003 cost sharing regulation is invalid. At the very least, the approach and rationale of the Ninth Circuit in *Xilinx* require affirmance of the Tax Court's decision in *Altera*. The IRS in *Xilinx*, upon the Tax Court's consideration of extensive evidence and arguments by the parties, could not sustain the IRS's assertion that sharing stock options clearly reflected income. All the more, a regulation that requires all taxpayers to share stock options, regardless of the facts, cannot be justified as clearly reflecting income.

Further, apart from the *Xilinx* decision, based on the *Chevron* standard, the 2003 cost sharing regulation is not a reasonable implementation of § 482. Section 482 applies when there are two businesses controlled by the same interests. In that situation, the Commissioner is given the authority to do only two things: clearly reflect income and prevent evasion of tax. Upon proving that a taxpayer's transaction produces the same result as if the parties were uncontrolled, the predicate in § 482 necessary for the Commissioner's authority (exercise of control that shifts income) has been negated. Because the taxpayer's transaction produces the same result as if the parties were uncontrolled, there is no evasion of taxes and the taxpayer's income is clearly reflected. Consequently, a § 482 regulation that requires a result that is demonstrably contrary to the result that would occur in the

same situation with uncontrolled parties exceeds the authority granted to the Commissioner in § 482. The regulation is, therefore, not a reasonable implementation of the statute, and so the unanimous full Tax Court in *Altera* correctly determined the 2003 cost sharing regulation to be invalid.

BACKGROUND

Xilinx received its Notice of Deficiency in December 2000 and filed a Petition in Tax Court in March 2001. At that time, the issue of including amounts for stock options in cost sharing was being litigated in *Seagate Technology, Inc. v. Commissioner.* Tax Court Case No. 15086-98. The Tax Court recently had issued an opinion on Seagate's motion for summary judgment. *Seagate Tech., Inc. v. Comm'r*, 80 T.C.M. (CCH) 912 (2000). The Tax Court denied Seagate's motion, concluding that neither party had advanced evidence or affidavits completely resolving, as a factual matter, the question of whether arm's length parties to a similar transaction would share employee stock options.[2] In August 2001, the IRS conceded the stock option cost sharing issue in *Seagate*. Xilinx wondered what the IRS would do with respect to the same issue in its case and soon found out.

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[2] *Seagate* dealt with the prior 1968 cost sharing regulation, Treas. Reg. § 1.482-2(d)(4) (1968). The 1995 cost sharing regulation at issue in *Xilinx* was issued as a result of the 1986 § 482 legislation and Congress' request that consideration be given to whether the existing § 482 regulations should be modified.

In the Fall of 2001, Xilinx's counsel received a telephone call from an IRS appeals officer who said that IRS counsel was considering designating Xilinx's stock option issue for litigation. "Designation for litigation" means that the IRS will not settle an issue except if the taxpayer completely concedes. Shortly after the call, Xilinx was informed by letter that IRS Chief Counsel had designated the stock option issue for litigation. Designation for litigation was a unilateral decision by IRS Chief Counsel.

Xilinx's notice of deficiency covered three taxable years, one of which was prior to the January 1, 1996 effective date of the 1995 cost sharing regulation, Treas. Reg. § 1.482-7 (adopted December 19, 1995). The designation for litigation covered only the two years that were subject to the 1995 cost sharing regulation.

Prior to the designation for litigation, the IRS had begun the regulation project to modify Treas. Reg. § 1.482-7(d) to explicitly treat the spread on exercise of employee stock options as a cost that must be shared in a cost sharing agreement.[3]

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[3] The background file documents to the 2003 cost sharing regulation included a post-briefing memorandum from Douglas Giblen to File dated August 13, 2001: "Section 482 Regulation (Stock Option Issues)." The memo stated: "On August 7, 2001, Douglas Giblen, on behalf of the team developing revisions to the § 482 regulations pursuant to the current Business Plan project, conducted a briefing on the proposed express inclusion of compensatory stock options in the cost pool under the cost sharing provisions of § 1.482-7."

Xilinx filed a motion for partial summary judgment on February 4, 2002. In addition to objecting to Xilinx's motion, on March 6, 2002 the IRS filed its own motion for partial summary judgment. The IRS motion asserted that 1) because the spread on exercise of a nonqualified stock option was an expense (deduction) for tax purposes, based on *Apple Computer, Inc. v. Commissioner*, 98 T.C. 232 (1992), and 2) that under the 1995 cost sharing regulation, the tax treatment of an item (and not the GAAP accounting treatment) determines what items are a cost, the stock option spread was required to be shared.[4]

The IRS memorandum supporting its motion made no mention at all about satisfying the arm's length standard or the commensurate with income requirement. The motion was solely based on the assertion that because the exercise of nonqualified stock options generated an expense for tax purposes, the amount was a cost for the 1995 cost sharing regulation and therefore was required to be shared. Whether the result was an arm's length result was apparently irrelevant to the IRS.

Xilinx, in June 2002, filed a second motion for partial summary judgment, this time asserting that the IRS's adjustment was arbitrary, capricious and

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[4] Not all option exercises result in a tax deduction. Options that satisfy the requirements of I.R.C. § 421(a) do not. Those Xilinx options were not included in the IRS's adjustment.

unreasonable because the IRS's inclusion of stock options produced a non-arm's length result.

On July 29, 2002, less than two months after Xilinx's summary judgment motion asserting that the IRS position produced a non-arm's length result, the IRS issued proposed amendments to Treas. Reg. § 1.482-7(d) that explicitly included stock options as a cost to be shared. 67 Fed. Reg. 48997. The preamble said the proposed regulations "clarify that stock-based compensation is taken into account ... and clarify the coordination of the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1." *Id.* at 48998. The preamble further stated, "[n]o inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of the final regulations." *Id.* at 49001.

The IRS certainly did not view the proposed amendments as a *change* to the cost sharing regulation that produced a different result. The IRS continued its summary judgment motion and, on September 16, 2002, filed its objection to Xilinx's second motion for summary judgment. Dkt. 52. The IRS's reply brief asserted that evidence of unrelated transactions was irrelevant for determining arm's length:

> Neither petitioner nor respondent has presented evidence of what "parties at arm's length ... in cost sharing arrangements" in fact do. Moreover, even if such evidence were presented, it would be irrelevant as a matter of law ....

IRS Opposition Brief, p. 9. Dkt. 53.[5] This was probably the first (and only) time that the IRS has asserted that evidence of unrelated party transactions is "irrelevant as a matter of law" to determine whether a result is arm's length.

In October 2003 (after the regulation was amended), the Tax Court denied both parties' summary judgment motions. Dkt. 97. The Tax Court's order determined that extant factual issues precluded summary judgment.

The IRS submitted its pre-trial memo on June 14, 2004. Dkt. 192. The IRS asserted that, as a factual matter, unrelated parties would share stock options in cost sharing arrangements that match cost sharing agreements as described in Treas. Reg. § 1.482-7.

> The relevant arm's length standard question, therefore, is whether unrelated parties, if constrained by the § 1.482-7 contractual structure, would have treated as costless and valueless the services of petitioner's R&D employees to the extent the employees were compensated with stock options rather than other forms of compensation.

Id. at 85-86.

> The fact that economic costs are both explicitly shared or reimbursed, and implicitly compensated, in unrelated party contracts, but only accounted for explicitly in a Treas. Reg. § 1.482-7 QCSA, establishes the contours of what a useful comparable uncontrolled transaction would be in this case.

Id. at 88.

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[5] Unless otherwise noted, all docket references are to *Xilinx. Inc. v. Commissioner*, No. 4142-01 (U.S. Tax Court).

At the trial, both Xilinx and the IRS presented evidence to support their assertions that not including or including stock options produced an arm's length result. Xilinx presented dozens of agreements of cost sharing transactions between unrelated parties. Xilinx also presented fact witnesses, including executives from various companies, who testified that stock options were not treated by companies as a cost or otherwise factored into any services, licenses or other agreements. Xilinx also submitted thirteen (13) opening expert reports, including reports by experts who negotiated various types of cost sharing and other intangible transfer agreements and by a former government contracting officer who reviewed U.S. government cost sharing agreements. A list of some of Xilinx's experts and the nature of their report follows.

- Dr. Mukesh Bajaj is a financial economist who spent seven years as an Assistant Professor of Finance and Business Economics at USC and taught courses in Corporate Finance, Investments and Financial Innovation at the Haas School of Business at the University of California at Berkeley. Based on his review of 325 agreements, he found no evidence that unrelated parties ever shared any amount for employee stock options. Dr. Bajaj discussed at length why, from a theoretical standpoint, stock options would not be shared at arm's length. He found no evidence to suggest that parties ever treated

stock options as creating a cost to the company that could be included in the pool of costs being shared with and/or reimbursed by third parties.

- Mr. Mark Edwards is the founder of several consulting firms that maintain databases of hundreds of business agreements, including dozens of cost sharing agreements. He testified on business practices; his expert report states that stock option compensation is not considered to be a cost in R&D alliances and that stock option compensation is not shared in R&D alliances, a conclusion supported by his review of his firm's databases of agreements.
- Ms. Karen Manos, a United States Air Force Academy graduate, has more than twenty years of experience in government contracts and has reviewed or negotiated several hundred government contract actions. She served as an Air Force judge advocate reviewing contracts and advising administrative contracting officers on issues involving contractors' compliance with the Federal Acquisition Regulation cost principles and Cost Accounting Standards. She achieved the highest level certification in government contracting. She chaired Howrey Simon Arnold & White, LLP's government contracts practice. Her expert report stated that government contracts are arm's-length

agreements and are generally competitively awarded and negotiated. R&D accounts for approximately twelve percent of the contract actions awarded by the federal government each year. The government uses cost-sharing contracts and cooperative agreements for R&D when the contractor is willing to absorb a portion of the costs in the expectation of future benefits, such as through the commercialization of any resulting intellectual property. In the context of government contracting, the government does not allow any cost for employee stock options granted at the money.

- Mr. Ray Ostby served in a number of executive positions in high technology companies and has extensive involvement with several hundreds of contracts relating to, but not limited to, customers for all types of products and services. He testified that stock option compensation is not a cost related to intangible development. His expert report stated that he "never—ever—even for a moment—considered in any way that stock options could be considered to be a cost." Ray Ostby, Report on Stock Options for Xilinx Case, p. 11.
- Mr. Stephen J. Zadig, with over thirty years of experience in the semiconductor industry, testified on industry practices, concluding that semiconductor firms typically go through a careful process, in

which all costs are considered to price products; and, stock options are not considered to be a cost in the semiconductor industry.

Although the IRS asserted that unrelated parties would include stock options in cost sharing agreements, the IRS presented no agreements *of any kind* that actually included stock option amounts. The IRS's only "factual" evidence was experts' reports and their testimony. The IRS presented five experts, including an economic expert (Scott Newlon) and a government contract specialist (Lee Schuh).

The IRS's economic expert, Scott Newlon, asserted that unrelated parties would include stock option expenses in cost sharing agreement. He acknowledged that stock option amounts were not explicitly included in cost sharing and other agreements. Nevertheless, he said that in a cost sharing agreement, unrelated parties would do so and that stock option amounts are implicitly included in agreements. He asserted that the many cost sharing agreements presented at trial were different than the type of cost sharing agreement described in the cost sharing regulation and thus were not comparable (and therefore not relevant).

Scott Newlon testified that business people who negotiated agreements would view stock options in one of two ways. He testified:

> If the management of companies really does not think or consider stock options as a cost (i.e., it is under the radar screen totally), then the same treatment should be done for Treas. Reg. § 1.482-7 and would produce an arm's length result.

Trial Transcript, pp. 1627-1628. Thus, based on one factual finding of what management thinks, Scott Newlon agreed that *not* sharing stock option amounts would be arm's length.

Xilinx introduced substantial evidence that stock options were not a cost for the cost sharing regulations and were not viewed as a cost by management.[6] That issue was, likewise, extensively briefed. So the evidence at trial supported Scott Newlon's view that excluding stock option actually produced an arm's length result.

In August 2005, the Tax Court issued its opinion in *Xilinx v. Commissioner*, 125 T.C. 37 (2005) determining that inclusion of stock option amounts in cost sharing agreements was not arm's length. The Tax Court did not determine that amounts for stock options generated a "cost" for the cost sharing regulation, and went on to say "Assuming *arguendo* that the spread and the grant date value are costs for purposes of section 1.482-7 ..., we conclude that respondent's allocations fail to meet the requirements of section 1.482-1(b), Income Tax Regs." *Id.* at 53.

In June 2009, the Ninth Circuit initially reversed the Tax Court decision with a 2 to 1 vote. All three of the Ninth Circuit judges agreed that inclusion of stock

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[6] *See, e.g.*, the expert reports of Mark Edwards, Ray Ostby and Stephen Zadig, discussed above. In addition, Dr. Charles Calomiris, Professor at Columbia University, testified in his export report at p. 3 that "neither the granting nor the exercising of stock options results in any gross or net costs to the firm, using the definition of cost employed by financial economists." Stock options do not reduce the value of the firm.

options *did not* generate an arm's length result. Nevertheless, the two judges in the majority determined that the IRS had the authority to issue a regulation under § 482 that required an adjustment that was not arm's length. The two judges decided that, even though the cost sharing regulation contradicted the requirement in Treas. Reg. § 1.482-1 that the arm's length standard "applied in every case," the cost sharing regulation should override Treas. Reg. § 1.482-1.

Throughout the *Xilinx* litigation, from the initial summary judgment motions through the pre-trial memoranda, the post-trial briefs and the Ninth Circuit appellate briefs (which covered nine different IRS briefs), the IRS had *never* asserted that stock option amounts should be included in cost sharing agreements, even if the results were not arm's length. The IRS never claimed that it has the authority under § 482 to issue a regulation that requires a non-arm's length result. Thus, the initial Ninth Circuit opinion adopted a position that the IRS had never asserted in nine previous briefs.

Xilinx requested reconsideration of the initial Ninth Circuit opinion. In the IRS's reply brief to Xilinx's reconsideration motion, the IRS supported the Ninth Circuit's conclusion, but said that it did not agree with the Ninth Circuit's reasoning. That is, the IRS *did not* support the conclusion that the IRS had the authority to issue a regulation that generated a non-arm's length result. The IRS

continued to assert that the requirement to include stock options in cost sharing automatically produced an arm's length result.

The Ninth Circuit withdrew its first opinion and issued a second opinion that upheld the Tax Court's decision. The Ninth Circuit's opinion stated:

> *Purpose*. Purpose is paramount .... 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.

598 F.3d at 1196. The Ninth Circuit held that the arm's length standard is the purpose of the § 482 statute and that a regulation cannot be construed to override the arm's length standard.

ARGUMENT

1. XILINX BELIEVES THE NINTH CIRCUIT'S DECISION IN *XILINX* HAS EFFECTIVELY ALREADY DECIDED THE INVALIDITY OF THE 2003 COST SHARING REGULATION.

All of the Ninth Circuit judges in *Xilinx* agreed that Treas. Reg. § 1.482-1 required the arm's length standard to be "applied in every case." All of the judges determined that inclusion of stock options produced a non-arm's length result. The initial majority opinion stated:

> 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 parties 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").

Xilinx, Inc. v. Comm'r, 567 F.3d 482, 491 (9th Cir. 2009).

All of the judges also agreed that Treas. Reg. § 1.482-7(d) required stock options to be cost shared (even though the Tax Court had not decided that issue). Thus, the three judges determined that the 1995 cost sharing regulation and Treas. Reg. § 1.482-1 conflicted.

The conflict between the two regulations was initially decided by two judges in favor of requiring the stock option amounts to be included, because the cost sharing regulation was a more specific regulation than Treas. Reg. § 1.482-1 and the IRS could issue a regulation under § 482 that required a result that was not arm's length. Upon reconsideration, the Ninth Circuit issued a new opinion that determined that the requirement of arm's length in every case took precedence over a requirement in the cost sharing regulation to include stock options. As the Court stated, the purpose of § 482 is paramount and that purpose of the statute is frustrated if the arm's length standard is trumped.

At issue in *Altera* is the validity of the changes made in 2003 to Treas. Reg. § 1.482-7, as well as the changes that were made in Treas. Reg. § 1.482-1 at the same time. The IRS's *Altera* brief states that the 2003 cost sharing amendments made two separate but interrelated changes. First, they clarified that stock based compensation is taken into account in determining costs for cost sharing, Treas.

Reg. § 1.482-7(d). Second, they clarified the coordination of the cost sharing rules with the arm's length standard in Treas. Reg. § 1.482-1.

The IRS argues that the first clarification makes the 2003 cost sharing regulation different than what the Ninth Circuit considered in *Xilinx*. However, that is not correct. All three of the Ninth Circuit judges determined that stock options were included under the 1995 cost sharing regulation. Since stock option amounts were already determined (or assumed) by the three Ninth Circuit judges to be a cost in the old regulation, a "clarification" or amendment to explicitly include stock option costs is not a change to the 1995 regulation. If stock option amounts were not deemed a cost under the 1995 cost sharing regulation, the Ninth Circuit would not have had to grapple with and resolve the very issue it decided—the conflict between Treas. Reg. § 1.482-7 and Treas. Reg. § 1.482-1.

Since the 2003 amendments were proposed in July 2002, after the parties had filed summary judgment motions in *Xilinx* but before the Tax Court had ruled on the motions, the IRS did not want to say that the 2003 amendments made a "change" to the 1995 cost sharing regulations to now include stock options. Use of "change" rather than "clarified" would have been an admission that stock options were *not* included in the 1995 cost sharing regulation. That statement and position would have undercut the IRS's summary judgment motion.

As further evidence that the IRS itself did not view the 2003 regulation as a change, the IRS amended its answer and its motion for summary judgment to exclude options granted prior to the beginning of Xilinx's cost sharing agreement. The IRS Notice of Deficiency had included these options, but to make its treatment of the 1995 and 2003 regulations consistent, the IRS amended its answer and summary judgment motion, reducing the amount of its adjustment by over 85%.

The other "clarification" made by the 2003 amendments was the "coordinating amendment" to Treas. Reg. § 1.482-1. The coordinating amendment added a sentence to Treas. Reg. § 1.482-1 that "Treas. Reg. § 1.482-7 provides the specific methods used to evaluate whether a [QCSA] produces results consistent with an arm's length result." Treas. Reg. § 1.482-1(b)(2)(i). A new paragraph was added to Treas. Reg. § 1.482-7(a)(3) that a qualified cost sharing arrangement ("QCSA") produces an arm's length result "if, and only if," each of the controlled participants share the costs, as determined under the revised cost sharing regulation, in amount equal to their share of reasonably anticipated benefits, and all the other requirements of the new cost sharing regulations are satisfied. This coordinating amendment, however, likewise, does not change the applicability of the decision of the Ninth Circuit in *Xilinx* or its rationale.

These coordinating amendments in 2003 merely state that the requirement to include stock options in cost sharing agreements produces (by administrative fiat)

an arm's length result. These statements in the regulations that including stock option costs automatically creates an arm's length result is no different than the IRS's assertions throughout the *Xilinx* litigation that including stock options in cost sharing produced an arm's length result. But, merely including a statement in the regulation that the IRS's litigating position in *Xilinx* produces an arm's length result does not make it an arm's length result. The regulation statements that the IRS result is arm's length does not change the initial *Xilinx* majority's conclusion: "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." 567 F.3d at 491. These coordinating amendments, based on no evidence, do nothing more than make the assertion that including stock options is arm's length because "we say it is."

The IRS in *Xilinx* argued extensively that including stock options produced an arm's length result automatically because the change to § 482 in 1986 added the commensurate with income sentence. The IRS in *Xilinx* repeatedly referred to the 1986 conference committee report discussion of cost sharing agreements to support its position that evidence about companies excluding or including stock options is not required or allowed in order to obtain an arm's length result. Thus, the arguments that the Commissioner makes in his *Altera* brief, that the coordinating amendments are permissible constructions of § 482 based on the commensurate

with income change and the 1986 legislative history, is just a repeat of the same arguments that the IRS made in the *Xilinx* case.[7]

All three of the Ninth Circuit judges in *Xilinx* determined that these IRS arguments, that the commensurate with income requirement, the 1986 legislative history, and the assertion that sharing costs reasonably reflects the actual economic activity, did *not* produce an arm's length answer.[8] All three judges determined

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[7] For example, the Commissioner stated in its reply brief to the Ninth Circuit in *Xilinx:*

> However, as demonstrated above, in adding the commensurate-with-income requirement to § 482 in 1986, Congress recognized the limitations of comparability analysis as a means of determining whether a controlled transaction involving intangibles satisfies the arm's-length standard. The promulgation of § 1.482-7 in 1995 properly implements the congressional objectives of the 1986 amendments to § 482 as they pertain to cost sharing arrangements ....

Appellant's Reply Brief, pp. 31-32 (Case Nos. 06-74246, -74269, Dkt. 34).

[8] Judge Fisher stated: "In particular, the Commissioner argues that ... it was proper for the IRS to require that in this narrow context the arm's length result should be defined by the 'all costs' requirement .... [T]he Commissioner's attempts to square the 'all costs' regulation with the arm's length standard have only succeeded in demonstrating that the regulations are at best ambiguous.[3]" 598 F.3d at 1198. "In writing that opinion, I was persuaded that the arm's length standard and the all costs regulation were in conflict ...." *Id.* at n.3.

Judge Reinhardt stated: "I, like Judge Fisher, am less than enthusiastic about the Commissioner's explanation of how he believes we should resolve this case. His preference is that we find somehow that the arm's length standard is met by way of the all costs requirement. I must confess that I have difficulty following his reasoning and, like Judge Fisher, am not persuaded by that argument." *Id.* at 1200 n.2.

that, in fact, including stock options in cost sharing agreements did *not* produce an arm's length result.

The IRS also had argued in *Xilinx* that the commensurate with income addition and the 1986 legislative history showed that it was appropriate to ignore evidence of unrelated parties and that external evidence may not be introduced to contradict the requirement of the cost sharing regulation to treat stock options as a cost (that evidence is "irrelevant as a matter of law"). Twice, all the Ninth Circuit judges rejected that assertion.

Moreover, the assertion that an arm's length result can be determined by ignoring all evidence of what unrelated parties actually do and would do in cost sharing arrangements is stated nowhere in the 1986 legislative history. Further, the Treasury Department's White Paper, produced in response to Congress' request for the study, nowhere states that the commensurate with income provision or the legislative history supports excluding evidence of arm's length transactions for cost sharing or for determining whether a result is arm's length. The White Paper, in fact, included a chapter on cost sharing agreements and specifically stated that "[c]ost sharing arrangements have long existed at arm's length between unrelated parties." Notice 88-123, 1988-2 C.B. 458, 493. The IRS' assertion that Congress intended that solely internal requirements for cost sharing always will produce an

arm's length answer, regardless of unrelated party transactions, is purely made up by the IRS. The Ninth Circuit in *Xilinx* rejected those arguments.

The same arguments in *Altera* thus provide no support for the 2003 cost sharing regulation. Because the same conflict between the cost sharing regulation and the arm's length requirement to be applied "in all cases" in Treas. Reg. § 1.482-1 is present in *Altera* as in *Xilinx*, and the rejection in *Xilinx* of the argument that all cost requirement generates an arm's length result, the 2003 regulation is invalid.

2. THE 2003 COST SHARING REGULATION IS NOT A PERMISSIBLE CONSTRUCTION OF § 482.

Under *Chevron* Step Two, an agency regulation will be upheld if the regulation is a permissible construction of the statute. All of 18 judges in *Altera* and in *Xilinx* that have considered the issue have decided that requiring an inclusion of stock options in cost sharing agreements produces a non-arm's length result. As described briefly above, Xilinx presented substantial evidence of unrelated party contracts and testimony of business executives and others who had negotiated agreements that inclusion of stock options does not occur. Comparability of the unrelated contracts was extensively debated.[9] The issue

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[9] The amicus brief of J. Richard Harvey, et al. asserts that "the question of comparability was not fully considered in the *Xilinx* case" and "[i]f the *Xilinx* litigation had included the question of whether the controlled and uncontrolled party joint development costs were comparable, perhaps that question would

under *Chevron* Step Two for *Altera* is then whether a regulation that requires a result that is not arm's length and that prevents any challenge to that non-arm's length treatment is a permissible construction of § 482.[10]

Section 482 authorizes the IRS to allocate gross income, deductions, credits or allowances when two or more businesses are controlled by the same interests, if such allocation is necessary to prevent the evasion of taxes or to clearly reflect income. Regulations under § 482 and its predecessor (§ 45 of the Revenue Act of 1928) have since 1935 stated that the purpose of § 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standards of an uncontrolled taxpayer, the true net income from the property

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have influenced the *Xilinx* outcome." Case Nos. 16-70496-97, Dkt. 32 at 20-21. Such assertions are made from ignorance. They are simply untrue.

None of the amici attended the Xilinx trial. The 13 taxpayer expert reports, the 5 IRS expert reports and the numerous rebuttal reports are not listed on the Xilinx docket sheet, so the amici are not likely to have read any of the more than 30 expert reports and cost sharing agreements that were appendices. The amici are not likely to have read the 4 post-trial briefs or reviewed the 2,500+ pages of the transcript.

The IRS consistently asserted that all of the dozens of cost sharing agreements presented by Xilinx were not comparable ("These [third party cost sharing] contracts are not comparable to petitioner's Treas. Reg. § 1.482-7 qualified cost sharing arrangement ('QCSA') with Xilinx Ireland, and are not reliable indicators of the results that would have been achieved had the parties to the Xilinx-Xilinx Ireland QCSA been unrelated." Dkt. 192, IRS Pre-Trial Memo, p. 50). The comparability of the transactions was a matter that was addressed extensively in examinations, cross examination and in post-trial briefs.

[10] *See* Ronald B. Schrotenboer, *The Arm's Length Standard and the Limits of IRS Authority*, 17 Transfer Pricing Report 430 (2008).

and business of the controlled taxpayer: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

The statute does not use the specific words "arm's length." However, the arm's length standard is contained in the language of § 482. The IRS agrees. The Commissioner's brief says "Implicit in that language [of § 482] is the recognition that in order to clearly reflect income, commercial transactions between commonly controlled entities should be priced as though the parties had been dealing at arm's length (*i.e.*, the arm's length standard)." Brief, pp. 49-50.

Moreover, the Ninth Circuit's *Xilinx* opinion states that the purpose is paramount and "[i]f the standard of arm's length is trumped by 7(d)(1), the purpose of the statute is frustrated." 598 F3d at 1196. Similarly, Judge Fisher said in his concurrence: "The treaty ... reinforce[s] the arm's length standard as Congress' intended touchstone for § 482." *Id* at 1198 n.1.

The statute provides that it applies only when two or more trades or businesses are controlled by the same interests. Thus, the predicate for applying § 482 is a controlled transaction. Controlled transactions can generate tax results that Congress did not want, that is, results different than uncontrolled transactions. However, the IRS was not given unfettered authority. The statute does not allow the Commissioner to distribute or apportion or allocate items in "whatever manner

the Commissioner deems appropriate." Rather, the authority of the Commissioner is stated "in order to" (1) prevent evasion of tax, and (2) clearly reflect income. Thus, the IRS can *only* do those two things. If there has not been any evasion of tax and income is clearly reflected, there is nothing that the IRS is authorized to do: what the Commissioner is statutorily authorized to do already has been accomplished.

The presence and exercise of control as a predicate for the Commissioner's authority in 482 was considered and confirmed by the U.S. Supreme Court in *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972). The Supreme Court held that the IRS allocation was improper because the bank could not legally receive the income allocated. The Supreme Court stated: "It is only where this power 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." *Id.* at 404-05. (emphasis added)

Thus, when the actual results of a controlled transaction are the same as would have been realized if the controlled transaction had been conducted between uncontrolled persons, the taxpayer's income in the controlled transaction has not been changed as a result of the existence or exercise of control. The exercise of control, in such a way that true taxable income has been understated, has been negated when the result of the controlled transaction is arm's length.

When controlled parties have the same income as uncontrolled parties, there has not been any evasion of tax.[11] The taxpayer has generated *the same* income that an unrelated party would have generated. Further, income is clearly reflected. When the controlled transaction produces the same income as an unrelated party would, a taxpayer's income is clearly reflected.[12] The existence and exercise of control, the basis for the Commissioner's authority, has not resulted in a difference when the taxpayer has an arm's length result. Thus, nothing needs to be done in order to "prevent the evasion of tax" or to "clearly reflect income."

In *Xilinx*, the taxpayer presented substantial unrefuted evidence that taxpayers do not and would not share stock options at arm's length,[13] and the IRS presented no transactional evidence that showed unrelated parties actually shared stock option in any situation.[14] The Tax Court ruled accordingly. The testimony and economic reasoning explained this real world conduct: the cost that some attribute to stock options can vary widely and one party to an agreement would not want to be forced to share a large and unpredictable amount not under their control.

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[11] The IRS in *Xilinx* and in *Altera* has not asserted that excluding stock options in cost sharing has resulted in evasion of tax.

[12] *See* Glen Kohl, *Clear Reflections on How the Ninth Circuit Got Xilinx Wrong*, 124 Tax Notes 259 (July 20, 2009) (the title refers to the initial 9th Circuit opinion).

[13] The same type of evidence (third party agreements, government contracts, expert comments) presented in *Xilinx* was presented to the IRS in response to the proposed regulation.

[14] Likewise, the IRS referenced no such evidence to support the regulation.

Requiring controlled parties to share such costs would cause them to be treated *differently* than uncontrolled parties in the same circumstances. Section 482 does not provide the IRS with the authority to tax controlled parties differently or more than uncontrolled parties when there is no tax evasion and no failure to clearly reflect income. *See Comm'r v. First Sec. Bank of Utah, N.A.*, discussed above.

The 2003 cost sharing regulation that requires a taxpayer to have *more* income than an unrelated party in the same transaction goes beyond preventing evasion of tax and clearly reflecting income. There has been no shift or deflection of income that the Commissioner is authorized under § 482 to balance. Thus, the action of the Commissioner is beyond the authority provided in § 482. A regulation that *frustrates the purpose* of the statute and which is contrary to *Congress' intended touchstone*, which the Ninth Circuit decided a non-arm's length regulation does, cannot be a permissible construction.

Consequently, the 2003 cost sharing regulation inherently is not a reasonable implementation of the statute, and therefore is invalid. That is exactly what the Tax Court in *Altera* determined. "Under *Chevron* step 2, we would conclude the final rule is invalid because it is 'arbitrary or capricious in substance,' ... and therefore cannot be justified as being a reasonable interpretation of what § 482

requires." 145 T.C. 91, n.29 (2015) (internal citation and quotation marks omitted).

3. THE "DESIGNATION" OF THE XILINX CASE SUBSTANTIALLY UNDERMINES THE ARGUMENTS THE COMMISSIONER NOW MAKES.

The fact that the Xilinx case was "designated" by the IRS for litigation (after the regulation project had begun) diminishes the government's argument that this Court's *Xilinx* decision does not or should not control here. The designation of *Xilinx* also further supports that the cost sharing regulation now at issue (and the government's conduct) is arbitrary, capricious, and unreasonable.

The standards for designating cases are set forth in the Chief Counsel Directives Manual ("CCDM"). Chief Counsel Notice, CC-2004-017. Similar designation rules were extant before. Under the designation procedure, cases were to be designated to "solve recurring significant issues," to "establish judicial precedent," and to "conserve resources," among other things. CCDM 35.3.14.2.

Very few tax cases are designated each year.[15] The tax bar has long understood that the designation power is reserved for cases where precedent is needed (and will be followed), regardless of whether the final judicial determination is desired by the IRS. The Chief Counsel at the time of the *Xilinx*

[15] From 2000 until 2004, only 13 cases were designated. Kenneth A. Gary, *ABA Tax Section Meeting: Government Not Afraid to Use Courts*, 2004 TNT 90-9 (2004).

case, John B. Williams, Jr., confirmed the tax bar's understanding in his comments entitled *Designating Cases for Litigation*, presented before the Tax Court Judicial Conference, April 24, 2003. He explained that the Chief Counsel's designation of cases for litigation is "significant" and "far from routine." The IRS, he said, fully agreed with and accepted the principle that designation is appropriate to prevent "depriv[ing] the taxpayer of a decision that would collaterally estop future disputes." *Id.* at 3. He elaborated: "some cases present recurring, significant legal disputes affecting large numbers of taxpayers, and the public deserves a definitive, precedential answer from the courts. The designation procedure addresses those situations." *Id*. at 3-4.

The *Xilinx* case was, under the IRS's guidelines, designated to establish clear precedent on a national issue of continuing importance. Presumably, consistent with Williams' comments, the case was chosen by the government for litigation to "estop future disputes" and to provide a "definitive" answer for the "large numbers of taxpayers."

The government's current attempt to semantically try to distinguish *Altera* from *Xilinx* runs counter to these principles. Quite apart from the specific language of the regulation at issue in *Xilinx*, the government sought judicial ratification of the principle that the IRS could determine arm's length conduct by administrative declaration, without considering actual uncontrolled parties'

conduct. This Court rejected that novel approach to section 482, which has a long-standing history of requiring consideration of the facts. Particularly since *Xilinx* was a designated case, the IRS should not be heard to relitigate this issue once again.

Even before Xilinx was producing (over many years and at substantial expense) volumes of evidence regarding stock options and many expert opinions, the IRS was developing a regulation that by fiat sought to ignore evidence of actual conduct and the arm's length standard embedded in § 482. Further, the IRS also later did not take into account information concerning actual conduct with respect to stock options that was provided in response to the proposed new regulation. That conduct—ignoring actual evidence provided at substantial taxpayer expense in a designated case—is arbitrary, unreasonable, and capricious. The IRS's conduct of drafting the regulation before *Xilinx* started and issuing the regulation before any decisions in *Xilinx*, and now ignoring and trying to distinguish the unfavorable conclusion in *Xilinx*, shows the IRS had made its regulation decision at the beginning, without regard to any evidence or comments. Particularly when the IRS goes through the very special process of "designation," ignoring the evidence that its own official actions adduce is patently unreasonable.

The Tax Court decision in *Altera* should be affirmed.

Dated: September 12, 2016 Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I certify that the attached brief is proportionally spaced, has a typeface of 14 points or more, and contains 6,979 words (based on the word processing system used to prepare the brief).

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on September 12, 2016.

I certify that all participants in the case are registered CM/ECF users and that the service will be accomplished by the appellate CM/ECF system, with the exception of the participant listed below, whom we will serve by U.S. mail.

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