

Transfer Pricing

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The Arm's-Length Standard: Why It Matters



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The Ninth Circuit's recent decision in *Xilinx*¹ is based, at bottom, on the conclusion that the cost sharing regulations set forth in Reg. §1.482-7 (1995) are incompatible with, and are wholly divorced from, the general arm's-length standard of Code Sec. 482. At least one pundit has cheered the decision, suggesting that the arm's-length standard should be abandoned in favor of formulary apportionment and that *Xilinx* represents a first step in that direction. Amid the hue and cry, it is useful perhaps to step back and contemplate why the arm's-length standard has not only been adopted by the United States, but by the international community as whole. The regulatory history of the cost sharing regulations, particularly when read in the context of the arm's-length standard as the international norm, reveals that Treasury and the IRS intended the cost sharing regulations to be fully compliant with and governed by the arm's-length standard, not distinct from or irreconcilable with the arm's-length standard. Given the regulatory history and the importance of the arm's-length standard in avoiding double taxation, the authors submit that the Ninth Circuit majority opinion in *Xilinx* erred in concluding that the arm's-length standard was irrelevant to the cost sharing regulations.

The Problem—How to Measure Profits Earned by Related Parties in Order to Avoid Double Taxation of International Commerce

The world today is more economically interdependent than at any point in history. Trillions of dollars

of goods, services and intellectual property routinely flow across borders. Generally, the free flow of goods, services and intellectual property among the countries of the world is thought to provide many benefits, including the belief that international trade results in a higher average standard of living and that strong economic ties among nations reduce the likelihood of armed conflict and war.

At the same time, each nation involved in international commerce has a parochial interest in raising revenues through taxation to fund that nation's government and spending priorities. The nations of the world impose taxes on international commerce under a variety of regimes, including not uncommonly an income tax. The taxation by more than one nation of the same profits can result in confiscatory rates of taxation that approach or exceed the entire profits in question.

The salutary benefits of international trade, however, are unquestionably dependent upon the profit motive of the participants in international trade. Simply put, if the risk or fact of confiscatory double taxation were significant, international trade would become unprofitable or minimally profitable, and the volume of international trade and its benefits would decrease.

The leading nations of the world have long recognized that the risk of—and actual imposition of—double taxation restricts international trade and must be avoided. The question is how to do so. The problem is particularly difficult in the context of cross border transactions involving related parties, as there is not only the threshold question of which profits a nation can tax, but also the additional question of how much profit is earned by each of the related parties. It is to this additional complication involving the allocation of profits among related parties that we address our comments.²

International Adoption of the Arm's-Length Standard As the Measuring Stick

As a theoretical matter, assuming that the threshold question of which profits can be taxed is answered, all that is required to avoid double taxation of profits earned by related parties is a consistent method by which the countries of the world measure the profits earned in their respective jurisdictions by the individuals and entities engaged in international trade.

The key here is consistency of approach. Theoretically, as long as all the nations are measuring with the same measuring stick, the profits should be taxed only once. Thus, if the goal is merely avoidance of double taxation, the choice of whether the arm's-length standard or some formulary apportionment method is used is irrelevant, so long as each nation uses the same measuring stick. The choice of measuring stick, however, may determine how profits are allocated among the various factors of production. Ultimately, the choice of the arm's-length standard, rather than a 3 or 4 or 5 factor formulary apportionment standard, reflects both a policy choice to "let the market decide" how profits should be allocated and a pragmatic recognition that formulary apportionment factors can be easily manipulated.

In the United States, courts have long looked to the arm's-length standard in grappling with the question of whether related entities have potentially used their affiliated status to manipulate the results of transactions. See, *Delameter Est.*, 1 Whart. 362 (Pa. 1836) (transactions accepted where parties dealt at arm's length); *United States v. Delaware, Lackawanna and Western Railroad Co.*, 238 U.S. 516, 530 (1915) (transactions set aside where parties did not deal at arm's length).

By the 1920s, Congress was concerned about the ability of taxpayers to shift or "milk" profits from one related corporation to another and enacted a series of statutes designed to prevent such shifting or milking of profits between related entities, which culminated in the adoption in the Revenue Act of 1928 of section 45, the predecessor to Code Sec. 482. See H.R. Rep. No. 70-2, at 16-17 (1927); S. Rep. No. 70-960, at 24 (1928). Section 45, as adopted in 1928, was virtually identical to Code Sec. 482, sans the Code Sec. 482 commensurate with income standard adopted by Congress nearly 60 years later.

The first cases arose under section 45 before the Treasury had promulgated regulations under the statute. The Board of Tax Appeals was thus writing on a blank regulatory slate when it decided the first cases applying section 45. See *Advance Cloak Co.*, BTA Memo. 1933-78, Dec. ¶33,078; *Gordon Can Co.*, 29 BTA 272, 275, Dec. 8,276 (1933); *Asiatic Petroleum Co.*, 31 BTA 1152, 1159, Dec. 8868 (1935), *aff'd* CA-2, 35-2 USTC ¶9547, 79 F2d 234; *Tennessee-Arkansas Gravel Co.*, B.T.A. Memo. 1938-240, 1938 B.T.A.M. (P-H) ¶38,240. In these cases, the courts held that the purpose of section 45 was "to place a controlled taxpayer on a parity with an uncontrolled taxpayer

for purposes of determining tax liability ... in order clearly to reflect petitioner's true income." *Tennessee-Arkansas Gravel Co.*, 1938 BTA Memo at 418. These cases expressly adopted the arm's-length standard as the measuring stick to determine whether related entities had improperly shifted or milked profits from one entity to another: "The purpose of [section 45] is to place transactions between related trades and 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 Co.*, 1933 BTA Memo. at 108.

In 1935, Treasury promulgated regulations under section 45. In so doing, Treasury not surprisingly adopted the analysis of the courts interpreting section 45, specifically the arm's-length standard. In regulatory words that echo still today, the then-new regulations declared that:

The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.

Article 45-1(b), Regulation 86 (1935). In turn, "true net income" was defined as the net income "which would have resulted to the controlled taxpayer, had it in the conduct of its affairs ... dealt with the other member or members of the group at arm's length." Art. 45-1(a)(6), Regulation 86 (1935). In language still found in the Code Sec. 482 regulations today, Treasury mandated that "The standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Art. 45-1(b), Regulation 86 (1935).

In 1932, the United States was quick to incorporate the arm's-length standard of section 45 into its first tax treaty with France. See CONVENTION CONCERNING DOUBLE TAXATION, U.S.-Fr., art. IV, Apr. 27, 1932, 49 Stat. 3145, 3146-47 (1935). The U.S.-France treaty was ratified by the U.S. in 1932. Article IV of the U.S.-France treaty adoption of the arm's-length standard was modeled on section 45. See Mitchell

B. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation of Income, Part II*, 3 Int'l Law. 129, 150 (1968). Mr. Carroll was, at the time of the negotiation and ratification of the first U.S.-French treaty, a Special Counsel to Treasury.

In 1933, the League of Nations commissioned Mr. Carroll to analyze the various transfer pricing regimes adopted by governments around the world. Mr. Carroll reported that the U.S. had adopted the "independent persons" method in section 45. Mitchell B. Carroll, TAXATION OF FOREIGN AND NATIONAL ENTERPRISES (Volume IV): Methods of Allocating Taxable Income, ¶387, at 110 (1933). That same year, the League of Nations followed the U.S. lead and published a draft model treaty adopting the arm's-length standard.

SEE DRAFT CONVENTION ADOPTED FOR THE ALLOCATION OF BUSINESS INCOME BETWEEN STATES FOR THE PURPOSES OF TAXATION, in Report to the Council on the Fourth Session of the Committee, Held at Geneva from June 15th to 26th, 1933, League of Nations Doc. C.399.M.204.1933.II.A. (1933), reprinted in 4 Joint Committee on Internal

Revenue Taxation, Legislative History of United States Tax Conventions, at 4244 (1962).

Over the last 75 years, largely as the result of vigorous and sustained efforts by the U.S., the arm's-length standard has been adopted as the international norm—the gold standard—by which the nations of the world allocate revenues, costs and profits among related entities.

In the Tax Reform Act of 1986, Congress amended Code Sec. 482 to add the commensurate with income standard and further directed the IRS to undertake a comprehensive study of the Code Sec. 482 intercompany transfer pricing rules to determine whether those rules should be amended. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986). In response, the IRS in 1988 issued Notice 88-123, *A Study of Intercompany Pricing under Section 482 of the Code*, 1988-2 CB 458 (the "White Paper"). As a threshold matter, the IRS had to confront the basic policy choice as to whether the U.S. should continue to use the arm's-length standard or adopt some other measuring stick, such as one of the flavors of formu-

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lary apportionment. The analysis and conclusions of the IRS in the White Paper are worth revisiting:

The problem of double taxation arising from different transfer pricing methods has been addressed through inter-government negotiation and agreement, principally in bilateral tax treaties that specifically provide for certain adjustments by the treaty partners to the tax liability of any entity when its dealings with related entities differ from those that would have occurred between unrelated parties. ...

* * *

The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases. This overwhelming evidence indicates that there is an international norm for making transfer pricing adjustments and that the norm is the arm's length standard.

It is equally clear as a policy matter that, in the interests of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over primary taxing jurisdiction in international transactions, the United States should continue to adhere to the arm's length standard.

White Paper, 1988-2 CB at 475 (footnotes omitted). These statements in the White Paper remain equally true today.

Is the “All Costs” Provision of Reg. §1.482-7(d)(1) (1995) “Distinct” from and “Irreconcilable” with the Arm’s-Length Standard?

The majority decision in the Ninth Circuit's opinion in *Xilinx* concluded that (a) the “all costs” provision of Reg. §1.482-7(d)(1) (1995) required all costs to be shared, even if arm's-length parties would not share

those costs; (b) unrelated parties acting at arm's-length would not agree to share the spread on exercise (i.e., the Code Sec. 83 expense) on the employee stock options at issue in *Xilinx*; (c) the “all costs” provision of Reg. §1.482-7(d)(1) was thus irreconcilable with the command of Reg. §1.482-1(b)(1) that the standard to be applied “in every case” is the arm's-length standard; and (d) the more specific regulation of Reg. §1.482-7(d)(1) should prevail over the general arm's-length standard of Reg. §1.482-1(b)(1). *Xilinx*, slip op. at 6162–71. Key to the majority's opinion is the view that “the two provisions establish distinct and irreconcilable standards for determining which costs must be shared between controlled parties in cost sharing agreements[.]” Slip op. at 6163.

But are the two provisions “distinct” and “irreconcilable?” A review of the regulatory history confirms that they are not, but rather are branches of the same tree.

The 1966 Proposed Regulations

Cost sharing regulations were first proposed by the Treasury and the IRS in the 1966 Proposed Regulations. The 1966 Proposed Regulations covered all aspects of transfer pricing, including cost sharing agreements. The 1966 Proposed Regulations provided for a detailed set of cost sharing rules, not unlike those reflected in the cost sharing provisions later in the 1992 Proposed Regulations and in Reg. §1.482-7 (1995). Compare Proposed Reg. §1.482-2(d)(4) (1966) with Proposed Reg. §1.482-2(g) (1992) and Reg. §1.482-7 (1995). Importantly, Proposed Reg. §1.482-2(d)(4)(iv) (1966) expressly provided for costs in cost sharing agreements to be shared on an arm's-length basis. Proposed Reg. §1.482-2(d)(4)(i) (1966) limited the Commissioner's discretion to make adjustments to cost sharing agreements to adjustments required to reflect an arm's-length sharing of the risks, benefits and costs.

The 1968 Final Regulations

Proposed Reg. §1.482-2(d)(4) was withdrawn in 1968 and replaced by the simpler final 1968 cost sharing regulation, Reg. §1.482-2(d)(4) (1968). Like Proposed Reg. §1.482-2(d)(4) (1966), Reg. §1.482-2(d)(4) (1968) expressly required costs in cost sharing agreements to be shared on an arm's-length basis. The final 1968 cost sharing regulation also similarly limited the Commissioner's discretion to make adjustments

to cost sharing agreements to adjustments required to reflect an arm's-length sharing of the risks and costs: "the district shall not make allocations with respect to such [bona fide cost sharing agreement] except as may be necessary to reflect each participant's arm's-length share of the cost and risks of developing the property." Reg. §1.482-2(d)(4) (1968). In a contemporaneous Treasury Department release explaining the final 1968 regulations, the Treasury explained the change in the cost sharing rules from the 1966 Proposed Regulations to the 1968 final regulations:

The regulations provide a means whereby the necessity of determining the arm's length charge may be avoided if the parties using the property enter into a bona fide cost sharing arrangement in connection with the development of the intangible property. Detailed rules with respect to the establishment of a bona fide cost sharing arrangement which appeared in the earlier proposed regulations have been eliminated in the final regulations. *These rules are replaced by a concise statement of general rules based on arm's length standards.* Treasury Department Release F-1217, at 5 (Apr. 16, 1968) (emphasis added).

The Treasury also explained that the cost sharing rule was a safe haven or prima facie to be applied at the taxpayer's choice, and that the taxpayer could always choose to opt to apply the general arm's-length standard instead:

The plan of the regulations is to describe the application of the arm's length standard generally and then to detail its application in five specific types of transactions. In each of these specific cases the general rule is first stated – that is, that the proper arm's length consideration will be determined with reference to all surrounding facts and circumstances. Next, in some instances, a safe haven or prima facie rule is provided. The safe haven or prima facie rule provides a specific rate or charge that will be accepted as arm's length unless the taxpayer (and not the Government) desires to establish a more appropriate rate. *Id.*, at 2.

For the next 27 years, Reg. §1.482-2(d)(4) (1968) governed cost sharing agreements and thus expressly required costs and risks to be shared on an arm's-length basis and expressly limited the Commissioner's

discretion to make adjustments to cost sharing agreements to those adjustments required to reflect an arm's-length sharing of the risks and costs.

The White Paper

After the adoption of the commensurate with income standard in 1986, the IRS and the Treasury took great pains in the White Paper to clarify that "Congress intended the commensurate with income standard to be consistent with the arm's-length standard, and it will be so interpreted and applied by the Internal Revenue Service and the Treasury." White Paper, 1988-2 CB at 458. "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." *Id.*, at 472 (footnotes omitted). "[T]he correct application of the commensurate with income standard is premised soundly on arm's length principles." *Id.* Accordingly, Treasury and the IRS "conclude[d] that the commensurate with income standard is fully consistent with the arm's length principle." *Id.*, at 458. With regard to cost sharing agreements, "The Conference Report accompanying the 1986 Act indicates that Congress did not intend to preclude use of bona fide research and development cost sharing arrangements. However, Congress expected the results produced under a bona fide cost sharing arrangement to be consistent with results under the commensurate with income standard." *Id.*, at 493. Having concluded that the commensurate with income standard was intended to be consistent with, and a mere clarification of, the arm's-length standard, Treasury and the IRS thus concluded that Congress intended cost sharing arrangements to continue to be governed by the arm's-length standard.

The 1992 Proposed Regulations

In 1992, Treasury and the IRS issued proposed regulations under Code Sec. 482, including new cost sharing regulations. See 1992-1 CB 1164 (Jan. 30, 1992). Proposed Reg. §1.482-2(g) (1992) again expressly provided for an arm's-length sharing of risks and costs. Proposed Reg. §1.482-2(g)(1)(i) (1992) provided:

(g) Sharing of costs and risks – (1) In general. – (i) Limitations on allocations. If a member of a group

of controlled taxpayers acquires an intangible as a participant in a qualified cost sharing arrangement, the district director may make allocations with respect to that acquisition *to reflect each participant's arm's length share of the costs and risks of developing the intangible, under the rules of this paragraph (g).* (Emphasis added.)

Proposed Reg. §1.482-2(g)(1)(ii) provides that "Paragraph (g)(4) of this section describes the allocations that may be made by the district director *to reflect an eligible participant's arm's length share of the costs and risks of developing intangible property in a qualified cost sharing arrangement.*" (Emphasis added.) The preamble to the 1992 Proposed Regulations explains that the district director may make allocations to cost shares under Proposed Reg. §1.482-2(g)(4) "to reflect each participant's arm's length share of the costs and risks of developing intangible property." 1992-1 CB at 1169. For example, if the intangible development encompassed by the arrangement is too broad or narrow, then an adjustment in participants' cost shares may be necessary to place the arrangement on an arm's length basis." 1992-1 CB, at 1170.

The 1993 Temporary Regulations

In early 1993, the Treasury and the IRS issued temporary regulations under Code Sec. 482. See T.D. 8470, 1993-1 CB 90 (Jan. 21, 1993). The 1993 Temporary Regulations did not address the proposed cost sharing regulations, but rather left in place Reg. §1.482-2(d)(4) (1968) and its express application of the arm's-length standard to cost sharing agreements.

Moreover, in the preamble to the 1993 Temporary Regulations, Treasury and the IRS revealed that they had received numerous comments from taxpayers, industry groups, professional groups, several treaty partners and a number of multilateral government organizations such as the OECD criticizing a number of aspects of the 1992 Proposed Regulations, including a perceived departure from the internationally accepted arm's-length standard. Preamble to 1993 Temporary Regulations, T.D. 8470, 1993-1 CB, at 92. In response, Treasury and the IRS again reiterated the position they had taken in the White Paper in 1988 that the commensurate with income standard was consistent with and equivalent to the arm's-length standard and further explained that the 1993 Temporary Regulations were drafted to remove

any doubt about the United States' intent to adhere to the arm's-length standard:

The scope and purpose provisions have been reorganized to make clear that the arm's length standard is the guiding principle for all allocations under section 482, and to provide additional guidance for determining comparability under the arm's length standard. Section 1.482-1T(a)(1) reaffirms that the purpose of section 482 is to ensure that taxpayers clearly reflect their income by placing a controlled taxpayer on a tax parity with an uncontrolled taxpayer[.] ...

* * *

Section 1.482-1T(b)(1) reaffirms that in determining a taxpayer's true taxable income, the standard to be applied is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer (the arm's length standard). In this respect, the regulations are consistent with the current regulations and reflect many comments on the proposed regulations, which stressed the importance of adhering to the arm's length standard. The arm's length standard is satisfied if the results of controlled transactions are consistent with the results that would have been realized had uncontrolled taxpayers engaged in a comparable transaction under comparable circumstances.

Preamble to 1993 Temporary Regulations, T.D. 8470, 1993-1 CB, at 92.

The 1994 Final Regulations

In 1994, the Treasury and the IRS published final regulations under Code Sec. 482. See TD 8552, 1994-2 CB 93. The 1994 Final Regulations, which again retained Reg. §1.482-2(d)(4) (1968), albeit renumbered as Reg. §1.482-2A(d)(4), generally followed the format and substance of the 1993 Temporary Regulations, including the intent to continue to adhere to the arm's-length standard. 1994-2 CB at 98-99. Consistent with the prior representations of Treasury and the IRS in the White Paper, the 1992 Proposed Regulations, and the 1993 Temporary Regulations to interpret the commensurate with income standard to be fully consistent with the arm's-length standard, the 1994 Final Regulations continue to hold to the same standard held by the

Treasury and the IRS since 1935: “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.” Reg. §1.482-1(b)(1) (1994).

The 1995 Final Cost Sharing Regulations

The final regulations under Reg. §1.482-7 (1995) were issued in late 1995. See T.D. 8632, 1996-1 CB 85. In the preamble to Reg. §1.482-7 (1995), the Treasury and the IRS explained that the new cost sharing regulations were intended to follow the policies of the 1992 Proposed Regulations and the approach of the 1994 Final Regulations:

Without fundamentally altering the policies of the 1992 proposed regulations, the final regulations reflect numerous modifications in response to the comments described above. They also reflect the approach of the final section 482 regulations relating to transfers of tangible and intangible property. T.D. 8632, 1996-1 CB, at 87.

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.

The basic policy choice in the 1992 Proposed Regulations relating to cost sharing was the continued adherence to the arm’s-length standard. See Proposed Reg. §1.482-2(g)(1)(i) (1992); Preamble to 1992 Proposed Regulations, 1992-1 C.B. at 1169-70. The approach of the 1994 Final Regulations is that “the governing principle under section 482 is the arm’s length standard”, T.D. 8552, 1994-1 CB at 98, and that the “standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.” Reg. §1.482-1(b)(1) (1995).

There is a difference among Reg. §1.482-7(a)(2) (1995) and all prior proposed and final cost sharing regulations with regard to the language used to limit the Commissioner’s discretion to make adjustments as to cost sharing agreements. Specifically, prior to the adoption of Reg. §1.482-7(a)(2) (1995), the express language of Reg. §1.482-2(d)(4), as well as the express language of the 1966 and 1992 Proposed Regulations, provided that “the district director shall

not make allocations with respect to [the cost sharing arrangement] except as may be appropriate to reflect each *participant’s arm’s length share of the costs* and risks of developing the property.” (Emphasis added.) Proposed Reg. §1.482-2(g)(1)(i) (1992) was similar: “the district director may make allocations with respect to [the cost sharing arrangement] to reflect each *participant’s arm’s length share of the costs* and risks of developing the intangible, under the rules of this paragraph (g).” (Emphasis added.) In contrast, Reg. §1.482-7(a)(2) (1995) provides:

The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled *participant’s share of the costs* (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. (Emphasis added.)

In Reg. §1.482-7(a)(2) (1995) the term “arm’s length” no longer modifies the word “costs.”

Does the absence of the “arm’s length” modifier evince an intent by Treasury and the IRS to deviate from the arm’s-length standard in Reg. §§1.482-7(a)(2) or -7(d)(1) (1995)? The authors think not. The Preamble to Treas. Reg. §1.482-7 (1995) specifically provides that the final cost sharing regulations do not fundamentally alter the policies of the 1992 Proposed Regulations and follow the approach of the 1994 Final Regulations. The policy and approach of both reflected an unambiguous reaffirmation of continued adherence to the arm’s-length standard. The Treasury and the IRS went out of their way in both the 1992 Proposed Regulations and the 1994 Final Regulations, in essence, to swear a veritable oath of fealty to the arm’s-length standard. Moreover, with regard to Reg. §1.482-7(a)(2) (1995) specifically, the Preamble provides:

Section 1.482-7(a)(2) restates the general rule of cost sharing in a manner intended to emphasize its limitation on allocations: no section 482 al-

location will be made with respect to a qualified cost sharing arrangement, except to make each controlled participant's share of the intangible development costs equal to its share of reasonably anticipated benefits.

1996-1 CB at 87. Thus, the Preamble to the 1995 Final Cost Sharing Regulations suggests no significant change from either the 1992 Proposed Regulations or Reg. §1.482-2(d)(4) (1968) in this regard. Moreover, Proposed Reg. §§1.482-2(g)(2)(i)(D) and -2(g)(2)(ii)(A) (1992) contained similar language about sharing "all costs" in proportion to benefits, but Proposed Reg. §1.482-2(g)(1)(i) (1992) nonetheless still limited the Commissioner's allocation authority to allocations necessary to make each participant bear an "arm's length share of the costs and risks of developing the intangible[.]" Given that the Preamble to the 1995 Final Cost Sharing Regulations emphasizes that this section was intended to emphasize its limitation on allocations, it would be inconsistent to read the absence of the term "arm's length" to expand the Commissioner's authority to make allocations with respect to cost sharing agreements.

Most fundamentally, any intended shift away from the arm's-length standard in the 1995 Final Cost Sharing Regulations not only is flatly inconsistent with the stated intent of Treasury and the IRS at the time, but it is completely inconsistent with their actions and representations since issuing those regulations.

For example, on September 20, 1996, less than a year after promulgating Reg. §1.482-7 (1995), the Treasury amended and restated the United States' Model Income Tax Convention, 1 Tax Treaties (CCH) ¶210, (the "1996 U.S. Model Treaty") and the Technical Explanation to the 1996 U.S. Model Treaty, Tax Treaties Rptr, (CCH) ¶216, (the "1996 Technical Explanation"). The 1996 Technical Explanation reports that the 1996 U.S. Model Treaty was based on the 1981 draft U.S. Model Treaty, the 1995 OECD Model Treaty, "existing U.S. income treaties, recent negotiating experience, current U.S. tax laws and policies and comments received from tax practitioners and other interested parties." 1996 Technical Explanation at 2. Article 9 of the 1996 U.S. Model Treaty provides that the arm's-length standard governs transfer pricing. The 1996 Technical Explanation makes plain that the arm's-length standard unambiguously applies to cost sharing arrangements. 1996 Technical Explanation at 43. The U.S. again amended and restated the United States' Model Income Tax Convention in 2006, Tax

Treaties Rptr. (CCH) ¶209 (2006) (the "2006 U.S. Model Treaty"), and the Technical Explanation to the 2006 Model U.S. Treaty, Tax Treaties Rptr, (CCH) ¶215 (2006) (the "2006 Technical Explanation"). With regard to cost sharing arrangements, the 2006 U.S. Model Treaty and the 2006 Technical Explanation are identical in all respects to the 1996 U.S. Model Treaty and the 1996 Technical Explanation. Then and now, the Treasury and the IRS took the position that the arm's-length standard governs cost sharing arrangements.

Consistent with its Model Treaties, the Technical Explanations to U.S. bilateral treaties since 1995 have similarly provided that cost sharing agreements are governed by the arm's-length standard.

Finally, neither the Treasury nor the IRS has ever taken the position that cost sharing agreements are *not* governed by the arm's-length standard.

Analysis of the Majority Opinion in Light of the Regulatory History

The Ninth Circuit majority in *Xilinx* summarizes its opinion as follows:

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, cost 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. Slip op., at 6163.

The regulatory history discussion above shows that cost sharing arrangements were not intended to be divorced from the arm's-length standard. In this regard, prior to Reg. §1.482-7 (1995), the cost sharing regulations had always been expressly governed by the arm's-length standard. When originally proposed as Proposed Reg. §1.482-2(g) (1992), Reg. §1.482-7 (1995) expressly was subject to the arm's-length standard. The Preamble to Reg. §1.482-7 (1995) explains that the final cost sharing regulations follow the policies of the 1992 Proposed Regulations and the approach of the 1994 Final Regulations and give no suggestion that the cost sharing regulations were intended to depart from the arm's-length standard. At the time, the Treasury and the IRS had been trying to assure treaty partners and taxpayers alike that no diversion from the arm's-length standard was intended.

Far from establishing a distinct and irreconcilable standard, this regulatory history shows that Treasury and the IRS intended that the "all costs" language of Reg. §1.482-7(a)(2) and -7(d)(1) (1995) was subject to, and consistent with, the arm's-length standard. Specifically, as emphasized in the White Paper, Treasury and the IRS viewed Congress as requiring cost sharing agreements to be governed by the commensurate with income standard. In the 1988 White Paper and in every public pronouncement since, Treasury and the IRS have interpreted the commensurate with income standard to be

consistent with, and a mere clarification of, the arm's-length standard.

In conclusion, the authors submit that the majority opinion in *Xilinx* failed to take account of the regulatory history of the cost sharing regulations, particularly in light of the international context in which Treasury and the IRS must necessarily operate. In light of the regulatory history and the international context, the majority should have interpreted the two provisions harmoniously, with Reg. §1.482-7 requiring an arm's-length sharing of the costs and risks of product development. It is instructive to note that the interpretation reached by the majority opinion, that the cost sharing regulations are distinct from and irreconcilable with the arm's-length standard, is not an interpretation that has ever been asserted by the Treasury or the IRS. Indeed, Treasury and the IRS now find themselves in an awkward position. While Treasury and the IRS no doubt are happy to be on the winning side of the majority opinion in a transfer pricing case, the basis for the opinion was never advocated by them and is inconsistent with their regulatory intent and their representations to our trading partners around the world. In light of the importance of the arm's-length standard to international commerce through the avoidance of double taxation, the authors will be very interested to see how Treasury and the IRS respond to, and what they say about, the majority opinion as the *Xilinx* case continues to move forward in the appellate process.

ENDNOTES

* In the interest of full disclosure, the authors and their firm represent amicus parties in the *Xilinx* litigation.

¹ *Xilinx, Inc.*, CA-9, 2009-1 USTC ¶150,405, 06-74246, 06-74269 (May 27, 2009), *rev'g*,

125 TC 37, Dec. 56,129.

² In recognition of the complexity of taxation and as a concession to the shortness of life, we do not address in this column the issues arising out of the threshold ques-

tion, including the various permutations of individual nation's reach and scope of taxation, anti-deferral regimes or the questions surrounding the definitions of permanent establishment.

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