Xilinx Revisited

By Reuven S. Avi-Yonah

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In this article, Avi-Yonah argues that the original *Xilinx* panel decision was correct and that the new one was the result of the government's refusal to accept the rationale of that decision. However, he also believes that taxpayers have won another transfer pricing battle, they could lose the war if Congress decides to adopt the budget proposals on transfers of intangibles.

On March 22 the Ninth Circuit released its new opinion in *Xilinx v. Commissioner*, *Doc 2010-6163, 2010 TNT 55-12*.[1] As has been expected since the panel withdrew its original opinion, it reversed itself and in a 2-1 opinion held for the taxpayer.

The opinion makes it pretty clear why the reversal occurred. It was the result of concentrated pressure by the international tax community and the fact that the government was unwilling to defend the theory on which the panel originally decided the case: that the arm's-length standard of the section 482 regulations does not apply to cost sharing.

Like Judge Reinhardt, I continue to believe that the original decision was correct. As explained in my previous article, the cost-sharing regulations are an implementation of the super-royalty rule added by Congress to section 482 in 1986, and Congress made it clear when it adopted the super-royalty rule that the rule was to be applied regardless of whether it was consistent with the arm's-length standard. Therefore, the correct standard for deciding cost-sharing cases is not the arm's-length standard, which is not in the code but only in the regulations, but rather the clear reflection of income standard, which is embodied in the first sentence of section 482 and applied to intangibles in the second sentence. Contrary to the majority opinion, congressional purpose clearly supports the position the panel took in the original opinion, not the position the majority took now.

This conclusion is not changed by the application of article 9 of the Ireland-U.S. treaty. As stated in the original opinion, article 9(1), which embodies the arm's-length standard, is subject to the savings clause and therefore cannot affect U.S. taxation of a U.S. resident like Xilinx. Article 9(2) is excepted from the scope of the savings clause, but that clause of article 9 relates to correlative adjustments, not to the arm's-length standard.

It is a pity that the government was unwilling, presumably because of pressure from the OECD, to defend the position taken by the original panel decision that the arm's-length standard does not apply to cost sharing. As the government cogently explained, Xilinx and its Irish subsidiary could not be compared to unrelated parties because they are related, which makes them jointly subject to fluctuations in the price of Xilinx stock in a way that would not apply in an arm's-length situation. Therefore, comparables to sharing the cost of stock options can never be found, and the arm's-length standard cannot be applied. As Congress correctly decided in 1986, in the case of transfers or joint development of intellectual property, a different standard must be applied — the clear reflection of income standard that underlies the original language of section 482 and the court decisions applying it in the long period it was implemented before the 1968 regulations.[2]

What happens next? The government will presumably continue to defend its position on stock options on the ground that it advanced before the panel, namely that it is consistent with the arm's-length standard. Meanwhile, however, another taxpayer win in a high profile transfer pricing case, together with the taxpayer win in *Veritas Software Inc. v. Commissioner*, 133 T.C. No. 14, *Doc 2009-27116, 2009 TNT 236-17*, cannot help but encourage other taxpayers to litigate rather than enter into advance pricing agreements. The salutary effect of the Glaxo settlement (a significant win for the government, even though there was no decision) is likely to be dissipated.

The taxpayers have won another battle. But they may yet lose the war. The Obama administration is advocating in its budget significant changes to the treatment of intangibles under section 482, and Congress may well go along. The data are clear: Armed with cost sharing and provisions like section 954(c)(6) that enable them to shift profits to low-tax locations without triggering subpart F, our multinationals are able to locate most of their overseas profits in jurisdictions with an effective tax rate

[1]For prior coverage, see *Tax Notes*, June 8, 2009, p. 1231, *Doc 2009-12396*, or *2009 TNT 108-18*.

[2]For the history, see Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length," *Virginia Tax Review* (1995).

of less than 10 percent, without paying any U.S. tax.[3] It is time for Congress to do something to level the playing field for small domestic businesses that are subject to the full 35 percent tax on their profits and that are our principal job creators.

[3]*See* Avi-Yonah, Clausing, and Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' 9 *Florida Tax Review* 497 (2009).

Treatment of Modified or Distressed Mortgage Loans by REITs

By Steven Z. Hodaszy

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The primary trade organization for the real estate investment trust industry has made a request to Treasury and the IRS for administrative guidance concerning the regulations for testing modified mortgage loans held by REITs and distressed mortgage loans purchased by REITs. In this article, Hodaszy argues that the trade group's request is really a proposal to relax the income and asset test requirements for REITs that hold those loans (which could properly be done only by Congress), and he concludes that, although a temporary change to the rules for testing modified loans may be appropriate in light of the credit crisis, the proposed changes to the rules for testing distressed loans purchased by REITs should be rejected altogether.

A. Introduction

The credit crisis has presented real estate investment trusts (REITs) with extraordinary challenges and opportunities. The challenges, of course, stem from the sharp declines in value of residential and commercial real estate during the last two years and from the simultaneous increases in delinquencies and defaults on residential and commercial real estate loans. Faced with a confluence of rising loan nonperformance and falling collateral values, many mortgage REITs (and other mortgagees) have increasingly had to make a difficult choice. When a mortgage loan becomes in danger of defaulting, the lender must decide whether to allow the loan to default and foreclose on the related mortgaged property (in which case the lender will typically recover only a fraction of the outstanding loan amount) or to modify the loan (often by extending terms to maturity, decreasing interest rates, or writing down principal amounts) to try to maximize the portion of the original loan that is ultimately repaid.

However, these same economic conditions create the potential for significant profits to mortgage REITs that purchase distressed mortgage loans, often for prices representing small fractions of the outstanding loan amounts. A REIT (or any other mortgage investor) that purchases a nonperforming loan at a deep discount to its outstanding principal amount can realize a substantial return by restructuring the loan and then receiving the cash flow generated once the borrower resumes making