Ninth Circuit upholds cost-sharing regulations in *Altera*

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In brief

The Ninth Circuit Court of Appeals in *Altera Corp. v. Commissioner*, in a 2-1 decision, has reversed the US Tax Court and has upheld the validity of the Treasury regulation (Reg. sec. 1.482-7A(d)(2)) requiring stock-based compensation costs to be included in the costs shared in a cost-sharing agreement (CSA). The Ninth Circuit reached the same conclusion it had reached in the opinion issued in July 2018, which was subsequently withdrawn presumably because one of the judges on the three-judge panel had died before the opinion was issued. The case subsequently was reheard by a reconstituted three-judge panel.

The Ninth Circuit's majority opinion determined that the regulation was a valid exercise of authority under Section 482 because (a) the arm's-length standard is a versatile concept that does not require strict comparability to the pricing practices of unrelated parties, (b) the commensurate-with-income standard authorized Treasury to apply alternatives to comparability approaches in the case of transactions involving intangibles, and (c) the regulatory preamble explained the Treasury's reasoning in sufficient detail to withstand challenge under the Administrative Procedure Act (APA).

Judge O'Malley dissented, concluding, as had the Tax Court, that Reg. sec. 1.482-7A(d)(2) (i) was invalid as a procedural matter because of Treasury's failure to comply with the APA in issuing the regulation, and (ii) was contrary to Section 482 as a substantive matter because it did not comport with the arm's-length standard and because a CSA does not constitute a transfer of intangible property to which the commensurate with income standard applies.

In detail

General observations

The *Altera* decision has direct relevance to companies with cost-sharing arrangements that have excluded stock-based compensation from cost-sharing reimbursements in reliance on prior judicial precedent. The IRS seems likely to pursue examination adjustments on this issue for prior open years. In addition, the Ninth Circuit endorsed a broad conception of Treasury's authority to fashion flexible rules under Section 482 that need not tie to arm's-length comparability, which could have implications for transfer pricing analyses of related-party transactions in general. Moreover, the court's deference to the regulations and its dismissal of the taxpayer's APA arguments could narrow the grounds on which taxpayers might challenge the validity of Treasury regulations in future litigation, as compared to the standards applied by the Tax Court.

The decision potentially is subject to further judicial review and thus is not yet final. Altera is entitled to request the Ninth Circuit to reconsider the decision, or could request the

US Supreme Court to review the decision. Moreover, the Tax Court's decision continues to represent Tax Court precedent in cases that are not appealable to the Ninth Circuit, which hears Tax Court appeals only in those cases involving taxpayers residing in California, Washington, Oregon, and several other Western states.

Possible further judicial review

The Ninth Circuit's *Altera* decision will be the final determination on the stock-based compensation issue in the case unless Altera seeks a rehearing in the Ninth Circuit (either by the deciding panel or by a larger panel of 11 Ninth Circuit judges sitting *en banc*), or petitions the US Supreme Court to review the decision.

Observation: Requests for rehearing are considered only in exceptional circumstances, and it is uncommon for a circuit court to accept such a request. An argument might be made that such an exceptional circumstance exists here, however, on the basis that the *Altera* opinion conflicts with prior Ninth Circuit precedent (as discussed below) and was accompanied by a strong dissenting opinion, or for similar reasons. Similarly, the chances that the US Supreme Court would accept a petition to review a circuit court decision such as this are not high in the absence of a split among circuits. The case could, however, potentially provide a vehicle for the Supreme Court to reconsider or limit the *Chevron* doctrine calling for judicial deference to agency regulations, which some Supreme Court observers have speculated is desired by certain current Supreme Court Justices.

The deadline for Altera to request a rehearing will expire on July 22. The deadline to petition the Supreme Court will expire 90 days after the Ninth Circuit enters its final judgment. A decision in the case would not represent a final decision subject to no further judicial review until the time for petitioning the Supreme Court for review of a Ninth Circuit decision expires, or a petition is filed but is denied by the Supreme Court, or the Supreme Court hears the case and issues a decision.

Factual background

Altera Corporation (Altera), a US company that develops and sells programmable logic devices, had entered into a research and development (R&D) CSA with its Cayman Islands subsidiary, Altera International (AI). For tax years 2004 through 2007, Altera granted stock options and other stock-based compensation (SBC) to certain employees, but did not include any SBC expenses in the pool of costs shared under the R&D CSA. The IRS asserted that Altera's failure to share SBC costs with AI violated regulations, issued in 2003, requiring that SBC costs be included in the costs shared under a CSA.

Procedural history

On July 27, 2015, the US Tax Court in *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), held that this rule (the SBC rule) was invalid. The Tax Court, in a unanimous opinion, found that Treasury and the IRS had failed to provide a reasoned basis for the SBC rule that was consistent with the arm's-length standard, in light of uncontroverted public comments submitted during the regulatory process showing that SBC costs would not be shared between unrelated parties in similar arrangements. For a summary of the Tax Court's decision, see the previous PwC Tax Insight issued August 6, 2015.

The Ninth Circuit on July 24, 2018, issued an opinion overturning the 2015 Tax Court decision in *Altera* and upholding the validity of the SBC rule, On August 7, 2018, however, the Ninth Circuit, on its own motion, withdrew its July 24 opinion. Judge Stephen Reinhardt, one of the judges on the three-judge panel who had heard the appeal, died before the July 24 opinion was issued. The majority opinion stated that Judge Reinhardt had formally concurred with the opinion prior to his death. For details regarding the original (now withdrawn) Ninth Circuit opinion, please see our Tax Insight dated July 27, 2018. On August 2, 2018, Judge Susan Graber was appointed to replace Judge Reinhardt on the Ninth Circuit panel assigned to the case, and the reconstituted panel then reheard the case.

In the opinion issued on June 7, 2019, the Ninth Circuit first determined that in promulgating these regulations, the IRS did not exceed the authority delegated to it by Congress under Section 482. The court noted that Section 482 does not speak directly to whether the IRS may require parties to CSAs to share employee stock compensation costs in order to receive the tax benefits associated with entering into a CSA. The court held that Treasury and the IRS reasonably interpreted Section 482 as an authorization to require internal allocation methods in the CSA context, provided that the costs and income allocated are proportionate to the economic activity of the related parties, and concluded that the regulations are a reasonable method for achieving the results required by the statute. The court therefore decided that the regulations were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984).

Section 482 and the arm's-length standard

As framed by the court, the issue was whether Treasury permissibly can allocate between related parties a cost that unrelated parties would not agree to share. On appeal before the Ninth Circuit, Altera argued that the arm's-length standard always requires a comparability analysis, and thus the IRS cannot mandate an allocation of costs between related parties in the absence of evidence that unrelated parties share the same costs when dealing at arm's length. The IRS responded that it is consistent with the arm's-length standard to apply a purely internal method of allocation that distributes costs between the parties in proportion to their income, relying in part on the commensurate-with-income (CWI) standard found in Section 482.

In analyzing this issue, the Ninth Circuit began with a detailed review of the history of Section 482 and its predecessors, related case law, and administrative interpretations. The court noted that the precursor to Section 482 was designed to give Treasury the flexibility it needed to prevent cost and income shifting between related parties for the purpose of decreasing tax liability. The court cited various early decisions that did not look strictly to comparable transactions, but rather looked to achieve 'fair' or 'reasonable' allocations (or applied similar principles) to meet the arm's-length standard. Although the Section 482 regulations issued in 1968 focused on comparability to unrelated-party transactions, the court found that this comparable-transaction standard was not used to the exclusion of other more flexible approaches.

The CWI standard was added as a second sentence to Section 482 in 1986. It provides: '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.' According to the court, Congress's enactment of the CWI standard was consistent with a more flexible view of Section 482, since the legislative history evidenced Congress's concern that strict adherence to an arm's-length comparability standard prevented tax parity with unrelated taxpayers and announced an intent that a CWI approach should displace a comparability analysis where truly comparable transactions cannot be found.

Observation: In finding that CWI was intended to 'displace a comparability analysis,' the majority opinion departs from a history of administrative and judicial interpretation that had reconciled the CWI standard with the arm's-length standard. For example, the Tax Court's decision in *Xilinx*, which ultimately was upheld by the Ninth Circuit, held that the CWI standard 'was intended to supplement and support, not supplant, the arm's length standard.' The IRS, in a 2007 Advisory Memo (AM-2007-007), issued well after the 2003 regulations at issue, stated that 'Treasury and IRS have long maintained in regulations and other published guidance that transfer pricing allocations pursuant to the provisions of either sentence [of Section 482] must be in accordance with the arm's length standard as the unifying principle,' and acknowledged that '[t]he regulation promulgated in 1935 under section 482's predecessor introduced the arm's length standard and it has been the constant in all transfer pricing regulations since.'

***Chevron*, *State Farm*, and APA analyses**

The Ninth Circuit then turned to the disputed SBC rule that was added to the cost-sharing regulations in 2003.

The court began by analyzing the substantive validity of the SBC rule under the standard set forth in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.,* 467 U.S. 837 (1984). Under *Chevron*, when Congress has not directly spoken to the precise issue under consideration (as here), the court must uphold the regulation in question unless it is arbitrary and capricious in substance or manifestly contrary to the statute in light of the statute's text, structure, and purpose.

The Ninth Circuit majority held that the regulation was not arbitrary and capricious or inconsistent with Section 482, relying in particular on its interpretation of the CWI provision. The court reasoned that by tying income allocations to the amount of income attributable to the transferred intangible, the CWI statute provided a purely internal standard for income allocations. The court cited legislative history indicating that the CWI provision's objective was to ensure that income allocations follow economic activity, and to grant Treasury the authority to develop methods that did not rely on analysis of problematic comparable transactions

Observation: In its 2007 Advisory Memo on CWI, the IRS stated that "[c]ertain passages in the Committee Reports arguably might be construed as an invitation to the Treasury and IRS to interpret the CWI standard in a manner that would depart from the arm's length standard. However…the expert agencies reaffirmed the primacy of the arm's length standard for transfer pricing."

The court then analyzed whether the procedural requirements of the APA were satisfied by applying the 'reasoned decision making' standard set forth in *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.,* 463 U.S. 29 (1983).

Altera argued that issuance of the SBC rule violated the *State Farm* standard because Treasury did not respond to public comments showing that unrelated parties would not share SBC costs. The Ninth Circuit did not accept this argument, concluding that Treasury's decision to rely on a purely internal allocation methodology justified its refusal to consider comments regarding unrelated party practices 'that proved irrelevant to its decision-making process.' It noted the regulatory preamble's explanation that the submitted comparable transactions did not share enough characteristics of related-party CSAs involving high-profit intangibles to provide useful guidance. Consequently, the court found that Treasury had given sufficient notice of what it intended to do and why, and thus there was no APA violation.

Altera next argued that the Treasury's asserted justification for the SBC rule was inconsistent with statements made during the rulemaking process, when Treasury claimed that the cost-sharing regulations were consistent with the arm's-length standard (as well as the CWI standard). The court found Altera's argument to be misplaced because it was founded on the incorrect belief that an arm's-length analysis always must be method-oriented, rooted in actual transactional analysis.

Stock-based compensation as a cost

Altera also argued that Treasury did not adequately support its position that SBC was a cost. The court rejected this argument, finding that logic supported Treasury's conclusion that arm's-length parties would not ignore SBC where it was a significant element of the activity covered in a cost reimbursement arrangement. The court gave significant weight to the treatment of SBC as an expense under the Internal Revenue Code and under current financial accounting standards, noting that 'a distinction exists between the economic costs of stock compensation - which are debatable - versus the accounting costs - which are not.' Because companies account for SBC costs, the court held it was reasonable for Treasury to provide for the allocation of these costs.

Treaties

The Ninth Circuit dismissed any concern that its interpretation of the arm's-length standard would upend US income tax treaties. The court noted that the CWI standard and the 2003 SBC rule in the regulations are effectively incorporated into recent US treaties, and that 'there is no evidence that our treaty obligations bind us to the analysis of comparable transactions.'

Xilinx

The court did not accept Altera's argument that the Ninth Circuit's previous decision in *Xilinx, Inc. v. Commissioner,* 598 F.3d 1191 (9th Cir. 2010), should control the outcome in this case. *Xilinx* had addressed whether SBC costs must be included in costs shared under a CSA during years before the 2003 SBC rule was issued. The Ninth Circuit had upheld the Tax Court's conclusion that a CSA did not have to include SBC costs under the pre-2003 regulations, based on evidence that arm's-length parties do not share SBC costs.

The *Altera* court held that *Xilinx* was not controlling precedent because (1) *Xilinx* did not address the Treasury's authority to mandate inclusion of SBC costs but merely considered which of two conflicting provisions in the pre-2003 regulations should be given priority, and (2) the *Xilinx* court did not consider the CWI standard. The Ninth Circuit noted that the 2003 SBC rule had clarified the regulations and resolved any inconsistency that existed in the pre-2003 regime. According to the court, 'Although the *Xilinx* panel could have reached a holding that would foreclose the Commissioner's current position, it did not.'

Observation: The *Altera* opinion appears to discount important aspects of the *Xilinx* court's reasoning that went beyond a mere construction of the prior regulatory provisions. In fact, *Xilinx's* conclusion rested specifically on the court's understanding of the mandates of the arm's-length standard as embodied in the statute: 'If the standard of arm's length is trumped by [the regulation at issue], the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.' 598 F.3d at 1196.

Dissenting opinion

In a detailed dissenting opinion, Judge Kathleen O'Malley disagreed with the majority's determination that Treasury had complied with the APA in issuing the 2003 SBC rule. Like the Tax Court, Judge O'Malley concluded that the Treasury had failed to provide a reasoned basis for the SBC rule and did not fairly signal to interested parties that it was departing from the historical arm's-length standard during the rulemaking process.

In particular, the dissent found Treasury's assertion that the CWI statute authorized it to dispense with a comparability analysis altogether to be a purely *post-hoc* justification for Treasury's adoption of the SBC rule (raised for the first time on appeal, long after the relevant regulation was issued). Judge O'Malley instead would have found, as had the Tax Court, that Treasury's explanation of its rule (to the extent any was provided) failed to satisfy the *State Farm* standard, and that Treasury did not provide adequate notice of its intent to change its long-standing practice of employing the arm's-length

standard and using a comparability analysis to get there.

Moreover, even if the SBC rule were not procedurally defective, Judge O'Malley would have found the SBC rule substantively to be arbitrary and capricious and contrary to Section 482. She disagreed with the majority's suggestion that the arm's-length standard mandated by Section 482 is a fluid concept that need not be based on comparability analysis. Further, she observed that the statutory exception allowing Treasury to apply a CWI standard rather than a comparability analysis applied only in the case of a 'transfer' of intangible property.

The sharing of costs under a CSA does not involve a 'transfer' of an intangible, according to Judge O'Malley, because a CSA is an agreement to develop (not transfer) intangibles, and each party's rights to exploit the cost-shared intangibles arise *ab initio* upon the creation of the intangible. She disagreed with the majority's contention that the term 'transfer' in the CWI statute could be construed broadly to encompass the allocation of rights to distribute intangibles to be created in the future, which do not currently exist and may never exist.

Consequently, Judge O'Malley would have affirmed the judgment of the Tax Court that expenses related to SBC are not among the costs to be shared in CSAs.

Observation: Implications for CSAs

The *Altera* decision directly affects companies that have entered into CSAs and provide SBC to employees engaged in cost-shared development activities. On the strength of the prior judicial precedent, some such companies have excluded SBC costs from the cost-sharing pool, taking the position that the 2003 SBC rule is invalid.

In a memorandum issued January 12, 2018, the IRS's Large Business & International Division (LB&I) instructed IRS examiners not to start any new examinations of CSA SBC issues, and to suspend any existing examinations of CSA SBC issues, while the *Altera* appeal was pending. As stated in the memorandum, once the outcome of the *Altera* appeal is known, LB&I is to reconsider the Directive and issue further instructions at that time. Assuming the *Altera* decision becomes final in its current form, the IRS can be expected to modify this instruction and to proceed with pursuing examination adjustments that enforce the SBC rule.

Once final, the Ninth Circuit's *Altera* decision will effectively represent precedent for taxpayers resident in the Ninth Circuit. The Tax Court decision remains precedent in the Tax Court outside cases appealable to the Ninth Circuit.

Observation: Implications for application of arm's-length standard in general

The Ninth Circuit's opinion has broad significance for transfer pricing issues beyond the particular question it directly addresses (whether SBC costs must be shared in a CSA).

The Tax Court's opinion had confirmed that Treasury's implementation of the arm's-length standard under Section 482 must be based on an empirical analysis, tied to evidence of how transactions are priced between unrelated parties. The Ninth Circuit rejected this conclusion, accepting the IRS's argument that it should be permitted to issue regulations under Section 482 modifying or even abandoning the arm's-length standard, at least from the perspective of having to determine how unrelated parties would behave under comparable circumstances.

Importantly, the Ninth Circuit rejected what it referred to as a 'traditional' arm's-length analysis, which it defined as an analysis that looks to comparable transactions among unrelated parties to achieve an arm's-length result. The Ninth Circuit concluded that a focus on strict comparability to the form or structure of arm's-length transactions might in various circumstances undermine the statutory goal of achieving parity of results between controlled and uncontrolled taxpayers. It viewed the 1986 addition of the CWI standard to Section 482 as 'displacing' a comparability analysis and authorizing 'internal' allocation methods that reflect Treasury's views as to the relative economic activity of each party.

Commentary: The Ninth Circuit's notion of the arm's-length standard as a fluid concept, not necessarily connected to arm's-length comparability, appears to depart from the accepted approaches commonly used by tax authorities to resolve transfer pricing issues in unilateral, bilateral, and multilateral cases. The uncertainty such a fluid standard might introduce would be exacerbated if tax authorities also embrace the court's conception of 'transfer' as encompassing an entity's pursuit of future development of intangibles, which goes beyond the common understanding of the term.

These aspects of the opinion may have particular resonance as the IRS and Treasury consider possible new interpretations of the arm's-length standard as part of the OECD's BEPS initiative. For example, some commentators have criticized the approach of allocating income among the members of a multinational group based solely on the location of so-called 'DEMPE functions' as inconsistent with a functional analysis examining how unrelated parties compensate not just functions, but

also ownership of assets and assumption of risks.

The rationale of the Ninth Circuit's opinion, however, could be viewed as limiting the extent to which such criticisms based on arm's-length principles might be accepted. Also, the opinion might possibly be cited in an attempt to support other theoretical transfer pricing methods not based on market comparables, such as formulaic profit allocations or imputing income to activities that do not involve actual intercompany transfers.

The uncertainty in the application of transfer pricing principles could expand if the IRS's newly won flexibility in defining the arm's-length standard is emulated by foreign jurisdictions imposing transfer pricing adjustments employing interpretations of the arm's-length standard based on their own, competing economic theories, rather than on empirical evidence of unrelated-party transactions. The flexible, fluid nature of the arm's-length standard endorsed by the Ninth Circuit thus could make it more difficult to resolve transfer pricing disputes under the Mutual Agreement Procedure article of tax treaties on a principled basis when foreign tax authorities have their own, conflicting economic theories of the arm's-length standard.

Observation: Implications for regulatory validity issues

The Ninth Circuit's interpretation and application of the APA have potential implications for the validity of other income tax regulations, particularly other transfer pricing regulations that might be challenged as insufficiently supported by fact-based evidence or empirical analysis. The Ninth Circuit opinion undercuts the Tax Court's view that the regulatory process leading to the adoption of the SBC rule was flawed in part because of Treasury's failure to develop a factual record. The court's willingness to credit Treasury's broad justifications for its actions, and to construe the regulatory record as containing sufficient support for the regulation to withstand APA scrutiny, in effect may limit the grounds on which other non-transfer pricing income tax regulations might be challenged as well.

Commentary: If fact finding or empirical analysis were required for Section 482 regulations, other parts of those regulations could be vulnerable to the same kind of challenge, since some methods prescribed in the regulations arguably do not match actual unrelated-party pricing arrangements found in the marketplace.

The takeaway

The Ninth Circuit decision in *Altera* affects the tax positions of companies that have related-party CSAs. Such companies should review their treatment of SBC costs under their CSAs in light of the new decision. With this decision, the IRS now can be expected to pursue adjustments on the CSA SBC issue for prior years.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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