Ninth Circuit Appellate Court Overturns Tax Court in Altera Case

DETAILED SUMMARY OF THE NINTH CIRCUIT'S OPINION

On July 24, 2018, the United States Court of Appeals for the Ninth Circuit released their decision on the appeal of the important *Altera* case (see decision here).[1] This case focused on the validity of amendments made to the intangible development cost sharing regulations in August of 2003 which explicitly required the inclusion of stock-based compensation (SBC) costs in intangible development cost (IDC) pools for qualified cost sharing arrangements (CSAs) under the 1995 Regulations. Prior to the 2003 amendments, the relevant regulations required taxpayers to share "all costs" of intangible development. Under those regulations, many taxpayers took the position that sharing of SBC expense was not a cost that was shared between unrelated parties and therefore inclusion of SBC costs were not required—a position that ultimately upheld in another tax court case (*Xilinx, Inc. v. Commissioner*, 124. T.C. 27 (2005), aff'd 598 F.3s 1181 (9 Cir. 2010), henceforth "Xilinx"). In the Xilinx opinion, which was effectively affirmed by the same appellate court hearing Altera after an en banc rehearing vacated its first panel opinion, the Tax Court found that Xilinx did not need to share SBC costs in CSAs because such a requirement was at odds with the arm's length standard under Section 482. This finding was rooted in a body of evidence presented to the court showing that in a broad variety of joint business ventures between unrelated parties, SBC costs were not shared among the participants, along with expert opinions that third parties would not agree to share such costs due to the inability to control such costs as well as moral hazard problems.

The Xilinx decision, issued two years after Treasury amended the cost sharing regulations to require inclusion of SBC costs in intangible development cost pools, created an obvious tension—could Treasury issue regulations that had been found, by the Tax Court, to be inconsistent with the arm's length standard?

The Altera Tax Court Case

Altera Corporation had been in a QCSA with a foreign subsidiary (Altera International) since 1997. In 2003, Altera made amendments to its agreement to comply with the amended cost sharing regulations. In 2005, the agreement was amended further after the opinion in Xilinx was issued, calling for the suspension of any portion of the cost sharing payment related to the inclusion of SBC costs in shared IDC pools unless and until a court upholds the validity of the amendments to the cost sharing regulations made by Treasury in 2003.

The IRS issued two notices of deficiency to Altera, applying the revised cost sharing regulations. The adjustments would have increased Altera's U.S. taxable income by approximately $80 million over four years. Altera challenged the IRS in court on the basis that the regulation itself is inconsistent with the arm's length standard based on the Tax Court's finding in Xilinx, and on the basis the Treasury had not followed appropriate rulemaking procedures in issuing the 2003 amendment.

The Tax Court found that the 2003 regulations were subject to the requirements of the Administrative Procedures Act (APA). Under Section 553(b) of the APA, an agency making rules must:

(1.) Publish a notice of proposed rulemaking in the Federal Register

(2.) Provide interested persons with an opportunity to participate in the rulemaking through the submission of written data, views or arguments with or without opportunity for oral presentation; and

(3.) "After consideration of the relevant matter presented… incorporate in the rules adopted a concise general statement of their basis and purpose."

Under APA Section 706(b), a court must "hold unlawful and set aside" agency action, findings, and conclusions that the court finds to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

Under case law (and especially *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Auto Insurance Co.,* 462 U.S. 29 (1983), henceforth the "State Farm" case), the court's review under this standard is narrow, and the court is not to

1 The Tax Court Case was Altera Corp. v. Com'r., 145 T.C. 91 (2015

substitute its judgment for that of the agency. However, the court must ensure that the agency is engaged in "reasoned decision making. This referred to as the "State Farm Standard." Altera argued that Treasury's rulemaking procedure should be evaluated under the State Farm Standard, and that Treasury did not meet this standard given the lack of response to voluminous public comments prior to enactment of the regulation regarding the non-arm's length nature of the proposed amendment and given the lack of any evidence that parties would share in SBC costs to demonstrate the congruence of the amended regulations with the arm's length standard generally.

The IRS, on the other hand, argued that they had met the reasoned decision-making standard (even if that standard applied). When Treasury released the final 2003 amendment calling for the inclusion of SBC costs in intangible development cost pools for CSAs, the preamble noted that SBC inclusion is consistent with the legislative intent underlying Section 482 and with the arm's length standard. This was because, in Treasury's view, it was Congress' intent that cost sharing arrangements would be consistent with the Commensurate with Income Standard (CWI Standard) introduced into Section 482 as part of the 1986 Tax Reform Act (1986 TRA). CSAs would be consistent with the CWI Standard, in Treasury's view, only if SBC's were included in IDC pools. Additionally, the preamble stated that the transactions cited by public commentators did not involve arrangements that were sufficiently comparable to QCSAs to draw the conclusions that sharing SBC costs is inconsistent with the ALS. In making these explanations, the IRS believed that Treasury had given adequate response to comments and had met appropriate rulemaking requirements, particularly as determined under *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984) (the Chevron standard), which the IRS viewed as being more deferential and as the appropriate standard for the 2003 regulation.

The Tax Court sided with Altera in its 2015 opinion, finding that the IRS hadn't responded adequately to the body of evidence produced in public comments. The court did not rehear this evidence but instead relied on the court's findings in Xilinx. The Tax Court's decision in Altera was based on a determination that Treasury had not engaged in the reasoned decision making required of it under the standards required by existing case law (under either the State Farm or the Chevron standard). This finding was based on conclusions that:

- The rulemaking lacked basis in fact given the evidence of third-party behavior (and given that Treasury had taken the position in the preamble and on other numerous occasions to argue that the requirement was consistent with the ALS). The Tax Court found that Treasury relied only on unsupported assertions regarding arm's length outcomes in arm's length CSAs without any evidence;
- Treasury failed to rationally connect the choice it made with the facts that it found. Many QCSAs do not relate to the high-profit intangibles that were the focus of the CWI standard introduced in the 1986 TRA. The regulations don't differentiate between CSAs involving high-profit intangibles and other types of CSAs as it relates to the treatment of SBC costs.

Consequently, the Tax Court found the 2003 amendment to the cost sharing regulations requiring inclusion of SBC costs in IDC pools to be arbitrary and capricious, and held the regulation to be invalid.

Once the Tax Court released its findings, many taxpayers either amended their agreements or followed clauses already in effect to exclude SBC costs from IDC pools. In many cases, taxpayers weren't reserving against this position in their GAAP financial statements (sometimes at the behest of their financial auditors).

The Tax Court's opinions potentially had far reaching implications beyond just the 2003 SBC CSA amendments—it could have raised the bar for new IRS regulations more generally and created more opportunities for taxpayer challenges to new regulations. Some practitioners believed that other important regulatory changes (such as the changes that had been made to regulations promulgated under Section 367 and to the aggregation principals in Section 1.482-1) might be subject to a challenge following the *Altera* decision.[2]

Reversal of the Tax Court Opinion by the U.S. Court of Appeals for the Ninth Circuit

On July 24, 2018, the Ninth Circuit released an opinion on an appeal of the Tax Court ruling in the Altera case, overturning the opinion of the Ninth Circuit. That Ninth Circuit opinion, however, was withdrawn on August 7, 2018, just two weeks after it was issued. Judge Stephen Reinhardt, who had sided with the majority in overturning the Tax Court's opinion, had passed away in March—months before the opinion was issued and some parties wondered about the propriety or issuing the final opinion several months after one of the three judges had passed away. You can read more about this in the TP Times released September 5, 2018 available here. After the withdrawal of the opinion, the three-judge panel was reconstituted, replacing Judge Reinhardt with Judge Susan Graber.

On June 7, 2019, the Ninth Circuit issued a new opinion in the appeal, again overturning the findings of the US Tax Court. Many of the primary lines of thinking appear, not surprisingly, to be similar to those expressed in the withdrawn opinion. The majority (2-1) opinion starts by stating that the parties agree that the arm's length standard applies to the question of the validity of the 2003 amendments but differ in their interpretation of how that standard may be met. The Ninth Circuit's characterization of these positions is that the taxpayer believes that Treasury must employ a comparability analysis using

2 The inclusion of much of the substance of these changes in the tax code as part of the Tax Cut and Jobs Act of 2017 may possibly have mitigated the likelihood of such a challenge

comparable uncontrolled transactions between unrelated business entities in all cases. Treasury, on the other hand, believes the standard requires that an arm's length result of tax parity between controlled and uncontrolled entities is reached, and that it can use a "purely internal" method of allocation, distributing the costs of employee stock options in proportion to expected benefit shares. The question the Ninth Circuit must address is whether Treasury's regulations are permitted under the statute.

The opinion delves into the legislative history, particularly focusing on the introduction of commensurate with income (CWI) language into the statute as part of the 1986 Tax Reform Act. In the majority's opinion, the CWI standard introduced in the modifications to Section 482 as part of the 1986 TRA were made in explicit recognition of the difficulty associated with finding appropriate comparable transactions for transfers of high-profit intangibles. The opinion states:

> "The decades following the 1968 regulations involved 'a gradual realization by all parties concerned, but especially Congress and the IRS, that the [ALS], firmly established….as the sole standard under section 482, did not work in a large number of cases, and in other cases its misguided application produced inappropriate results. The result was a deliberate decision to retreat from the standard while still paying lip service to it. "

The majority opinion also refers to Treasury's transfer pricing "White Paper"[3] published in 1988, which stated that the CWI standard was consistent with the arm's length standard (and that Treasury believed that Congress shared that understanding). Further, the White Paper explicitly recognized that a comparability analysis must be performed where possible, but that a "clear and convincing" evidence standard was to be applied to the question of comparability, and that a comparability analysis would rarely be possible. In the majority's view, the White Paper signaled a shift in the interpretation of the arm's length standard relative to the 1968 transfer pricing regulations. It attempted to synthesize the arm's length standard and the CWI provisions—resulting in the introduction of the basic arm's length return method.

In the majority's view, Congress intended the commensurate with income standard to displace comparability analysis where comparable transactions cannot be found—including situations involving intangible transfers (like CSAs). The 1995 Cost Sharing regulations implemented the CWI standard through the requirement that "all costs incurred that are related to the development of intangibles" be subject to sharing under the CSA. They did not explicitly address the treatment of stock option expense in some part, in the majority's view, because the use of stock options as compensation didn't become commonplace until the 1990s. Treasury first expressed an explicit view on SBC in 1997, interpreting the all costs language of the 1995 regulations to include SBC. When it issued the 2003 amendment to the cost sharing regulations that explicitly addressed the inclusion of SBC, Treasury stated that it intended the amendments to be clarifications of the 1994 and 1995 transfer pricing regulations rather than an overhaul of them.

The majority opinion examines the question of whether the 2003 regulations were lawful under both the *State Farm* and the *Chevron* standard. It finds that:

(1.) In evaluating the amendment under the *State Farm* standard, the statute is silent on the question of inclusion of SBC costs in cost sharing pools. Therefore, the court must defer to Treasury's interpretation of the statute so long as it is based on a permissible construction of the statute (i.e. the interpretation isn't arbitrary, capricious or manifestly contrary to the statute). The majority believes that Treasury's interpretation of the statute is permissible based on the legislative history discussed above. Specifically, they find that 1986 TRA amendments delegated authority to Treasury to select the method needed to achieve the ends that the introduction of CWI was trying to achieve. CWI itself is an internal standard, not based on comparability analysis—a clear indication that Congress intended Treasury to be able to depart from such an analysis when necessary to get an appropriate result. The majority also finds as reasonable Treasury's determination that the uncontrolled arrangements presented by commentators as comparable do not provide helpful guidance regarding allocations of employee stock compensation. Therefore, in the conclusion of the *State Farm* analysis, the majority finds that "[w]hile interpreting the statute to do away with reliance on comparables may not have been 'the only possible interpretation' of Congress's intent, it proves a reasonable one."

(2.) Under the *Chevron* standard, the rulemaking process was not fundamentally flawed. This is because the only part of the rulemaking process that seems to be at issue is the question of whether the agency appropriately considered and responded to significant comments received during the period for public comment following the issuance of the proposed regulations. Altera and its counsel had argued that Treasury had not appropriately considered and responded to the considerable volume of evidence about the sharing (or lack thereof) of SBC expense in unrelated party agreements that are comparable to cost sharing arrangements. In the notice of proposed rule-making, Treasury made clear that it was relying on the CWI provision, and drew upon the legislative history around the 1986 amendment, explaining that Congress intended a party to a QCSA to bear its portion of all development costs. It also stated its intention that

3 *A Study of Intercompany Pricing Under Section 482 of the Code, I.R.S.* Notice 88-123.

these regulations conform with the arm's length standard. The majority opinion finds that Treasury dismissed the comments based on the fact that Treasury, in the preamble to the final rule, explained that it and the IRS did not agree with the comments that inclusion of SBC would be inconsistent with the arm's length standard in the absence of evidence that third parties do the same. They further argued that the arrangements that were presented as evidence to the contrary were not sufficiently comparable to draw a conclusion about the appropriate answer under the arm's length standard. Treasury was not, therefore, trying to validate their regulations relative to an analysis of comparable transactions because it reasoned that the transactions presented as evidence were not sufficiently comparable to warrant consideration as evidence – a finding the majority found reasonable in their *State Farm* analysis. For this reason, the majority finds that the comments regarding the evidence from third party arrangements were not "significant" comments within the meaning of Section 706 of the APA and therefore did not require the consideration outlined therein.

> "In sum, we cannot find a failure in Treasury's refusal to consider comments that proved irrelevant to the decision-making process…because the comments had no bearing on the "relevant factors" to the rulemaking, nor any bearing on the final rule, there was no APA violation."

The dissent from Justice O'Malley is also very similar to that which she wrote in association with the withdrawn 2018 appellate opinion. She finds that the majority has gone out of its way to justify the agency's rulemaking based on grounds that weren't invoked when the rules were being made—a direct violation of what is permissible under case law. In enacting the 2003 amendments to the cost sharing rules, Treasury repeatedly stated that they believed they were being consistent with the ALS—something that's not true based on the finding of Xilinx.

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