Miller & Chevalier

Tax Court in Altera Invalidates the Cost Sharing Regulations Provision Governing Stock-Based Compensation: The Treasury Failed to Engage in "Reasoned Decisionmaking" as Required by the APA

Tax Alert
08.13.2015

In *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (July 27, 2015), the Tax Court put the Internal Revenue Service (IRS) and U.S. Department of the Treasury (Treasury) on notice that when promulgating regulations premised on "an empirical determination," the factual premises underlying those regulations must be based on evidence or known transactions, not on assumptions or theories. If not, the regulations do not comply with the requirements of the Administrative Procedure Act (APA). Applying the arm's length standard underlying section 482,[1] the decision in *Altera* provides another example of transfer pricing litigation being decided on the basis of evidence of actual arm's length dealings rather than economic theories. It is also an important reminder to the IRS and Treasury that tax regulations are subject to the same APA procedures as regulations issued by other federal agencies. As a result, Treasury cannot ignore the evidence and comments submitted during the rulemaking process. If it is to reject that evidence, Treasury must engage in its own fact finding, and it must explain the rationale for its decision based upon the factual evidence.

Because of its specific impact on the regulation of cost sharing agreements and, more generally, because it could open the door to APA challenges to other regulations, including but not limited to other transfer pricing rules, the government will strongly consider an appeal of this decision. Because there is not yet a final order in the *Altera* case, the time for taking an appeal is not yet ripe. Appeal would lie to the Ninth Circuit.

The Context for the Dispute

Altera considers the validity of a regulation promulgated under section 482 under the standards set forth in *Mayo Found. for Med. Res. v. United States*, 562 U.S. 44 (2011). In that decision, the Supreme Court held that Treasury regulations are entitled to deference under the same standard articulated in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), which governs regulations promulgated by any other federal agency. Section 482 authorizes the IRS Commissioner to allocate income and expenses among related parties to ensure that transactions between them clearly reflect income. Treas. Reg. § 1.482-1(b)(1) provides that "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." In 1986, Congress amended section 482 to provide that, "in the case of any transfer (or license) of intangible property ..., the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1231(e), 100 Stat. at 2562. As noted by the Tax Court in *Altera*, Congress enacted this amendment to section 482 in response to concerns regarding the lack of comparable arm's length transactions, particularly in the context of high-profit-potential intangibles. In enacting this amendment, however, Congress did not intend to preclude the use of bona fide cost sharing arrangements (as defined under longstanding regulations) under which related parties that share the cost of developing intangibles in proportion to expected benefits have the right to separately exploit such intangibles free of any royalty obligation. H.R. Conf. Rept. No. 99-841 (Vol. II), at II-637-II-638 (1986), 1986-3 C.B. (Vol. 4), 1, 637-638.

In 1995, the Treasury issued detailed new cost sharing regulations that generally authorized the IRS "to make each controlled participant's share of the costs ... of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development." In *Xilinx, Inc. v. Commissioner*, 598 F. 3d 1191 (9th Cir. 2010), the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's holding that the regulations did not require the taxpayer to include employee stock options (ESOs) granted to employees engaged in development activities in the pool of costs shared under the cost sharing arrangement with its subsidiary. The Ninth Circuit reasoned that the term "costs" in the regulation did not include ESOs because that would not comport with the "dominant purpose" of the transfer pricing regulations as a whole, which is to put commonly controlled taxpayers at "tax parity" with uncontrolled taxpayers. Because of the overwhelming evidence that unrelated parties dealing at arm's length in fact do not share ESOs in similar co-development arrangements, the Ninth Circuit concluded that such tax parity is best furthered by a holding that the ESOs need not be shared.

In 2003 (prior to the *Xilinx* decision), the Treasury amended the transfer pricing regulations that were applicable to the years at issue in *Xilinx*. The amended regulations explicitly address the interaction between the arm's length standard and the cost sharing rules, and the treatment of stock-based compensation in the cost sharing context. Treas. Reg. § 1.482-1(b)(2)(i) now states that "Treas. Reg. § 1.482-7 provides the specific methods to be used to evaluate whether a cost sharing arrangement ... produces results consistent with an arm's length result." Treas. Reg. § 1.482-7(d)(2), as amended, specifically identifies stock-based compensation as a cost that must be shared.

Altera Corp. is a U.S. corporation that entered into a technology research and development cost sharing agreement with a Cayman Islands subsidiary. They did not include ESOs or other stock-based compensation in the cost pool under the cost sharing agreement. The IRS issued a Notice of Deficiency with respect to tax years 2004 through 2007, asserting that those costs should be included in the pool, and that, as a result of this inclusion, Altera's income should be increased by approximately $80 million in the aggregate.

The Tax Court's Analysis

Ruling on cross motions for summary judgment, the Tax Court, in a 14-0 decision reviewed by the full court, agreed with the taxpayer that the 2003 amendments to the cost sharing regulations were invalid under the APA because the Treasury did not adequately consider the evidence presented by commentators during the rulemaking process that stock-based compensation costs are not shared in actual third-party transactions.

As a threshold matter, the Tax Court sought to determine whether the 2003 regulations were governed by APA § 553. To that end, it analyzed whether the regulations were "legislative" (regulations that have the force of law promulgated by an administrative agency as the result of statutory delegation) or "interpretive" (mere explanations of preexisting law). This legislative/interpretive distinction under the APA is different from the distinction between legislative and interpretive Treasury regulations that was applied for many years in tax cases. That distinction was rendered largely obsolete by the Supreme Court's *Mayo* decision. Relying on *Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082 (9th Cir. 2003), the Tax Court found that the 2003 cost sharing regulations were legislative because there would be no basis for the IRS's position that the cost of stock-based compensation must be shared under section 482 absent the regulation and because the Treasury invoked its general legislative rulemaking authority under section 7805(a) with respect to the regulation.[2]

Because the 2003 cost sharing regulations were a legislative rule, their promulgation was required to comply with APA § 553, which generally requires the administrative agency to publish a notice of proposed rulemaking in the Federal Register, provide interested persons an opportunity to participate in the rulemaking through written comments and incorporate in the rules adopted a concise general statement of their basis and purpose. Further, APA § 706(2)(A) provides for judicial review of agency regulations: regulations can be invalidated where the court finds the rule to be "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law." The Tax Court cited *Motor Vehicles Mfrs. Ass'n v. State Farm*, 463 U.S. 29 (1983), as providing insight to this standard, stating that a regulation may be arbitrary or capricious if it is not based on consideration of the relevant factors and involves a clear error of judgment.

The IRS asserted in *Altera* that the 2003 cost sharing regulation should be reviewed under the two-step analysis of *Chevron v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). Under *Chevron*, a court must determine first if Congress has directly and clearly spoken on the issue. If so, then the court must give effect to Congress's clear intent. If not, a court must defer to the agency's interpretation of an ambiguous statute unless it is arbitrary, capricious or manifestly contrary to the statute itself. The Tax Court questioned this assertion, citing the recent Supreme Court decision of *Judulang v. Holder*, 132 S. Ct. 476, 483 n.7 (2011), for the principle that in cases where the regulation does not rely on the agency's interpretation of statutory language, *State Farm* is the correct framework. Echoing *Judulang*, however, the Tax Court described the issue as "immaterial" in *Altera* because the second step of the *Chevron* analysis incorporates the *State Farm* reasoned decisionmaking standard.

The Tax Court found that the stock-based compensation rule did not comply with the reasoned decisionmaking standard because the rule lacked a factual basis and was contrary to evidence before the Treasury during the rulemaking process. The Tax Court stated that, although the preamble to the 2003 rule stated that unrelated parties entering into cost sharing agreements typically would share ESO costs (thereby relating the regulation to the arm's length requirement of section 482), the Treasury had no factual basis for this assertion. Commentators had provided substantial evidence that stock-based compensation costs were not shared in actual third-party agreements, which the Tax Court itself had found (and which the government conceded) in *Xilinx*. The Treasury could draw no support from any of the submitted comments nor did it engage in any of its own fact finding to support its position. Absent such fact finding or other evidence, the Tax Court concluded that "Treasury's conclusion that the final rule is consistent with the arm's-length standard is contrary to all of the evidence before it."[3]

The Tax Court also stated that Treasury's failure to respond to any of the comments submitted was evidence that the regulation did not satisfy the *State Farm* standard, stating "[a]lthough Treasury's failure to respond to an isolated comment or two would probably not be fatal to the final rule, Treasury's failure to meaningfully respond to numerous relevant and significant comments certainly is [because m]eaningful judicial review and fair treatment of affected persons require an exchange of views, information and criticism between interested persons and the agencies." (Internal quotation omitted). As a result, the final rule failed to satisfy *State Farm's* reasoned decisionmaking standard.

Challenges for the Treasury

The *Altera* decision, absent a reversal on any appeal, highlights the limitations of the Treasury's rulemaking authority when the regulation is based on a factual determination. In that situation the deference normally given to the Treasury because of its expertise as an administrative agency carries little weight unless it is supported by specific fact finding the Treasury has done with respect to the rule at issue. In other words, the Treasury cannot expect tax regulations that seek to implement a fact-based standard to be upheld simply because the Treasury believes that they reach the right theoretical result. Instead, the Treasury must explicitly cite the evidence and explain how that evidence provides a rational basis for the regulation.

The *Altera* decision should motivate the Treasury to incorporate responses to submitted comments in its descriptions of final regulations. By specifically citing Treasury's failure (1) to respond to comments or (2) to engage in independent fact finding as being important components of judicial review under the APA, the Tax Court all but directs the Treasury to spend more resources during the rulemaking process.

More broadly, the *Altera* decision underscores the constraints placed on the Treasury and other administrative agencies under the APA. Although *Mayo* announced that *Chevron* deference principles would apply to Treasury regulations in the future, that decision was not a radical shift in the law because Treasury regulations had always been subjected to a deference analysis that bore considerable similarity to *Chevron*. By contrast, as the Tax Court noted, Treasury regulations have not traditionally been measured by APA standards, and the Treasury's notice-and-comment procedures have not been analyzed under *State Farm*. The Tax Court's unanimous decision in *Altera* shows that judicial review under the *State Farm* standard is more than a mere paper tiger:

where the Treasury does not demonstrate that it adequately considered the relevant factors, including submitted comments, its regulation is at risk of being overturned. Although *Altera* as of now is binding authority only in Tax Court cases, challenges to Treasury regulations in other forums likely will cite its reasoning with respect to what constitutes reasoned decisionmaking for purposes of judicial review under the APA.

Considerations for Taxpayers

Absent reversal on appeal, *Altera* will have an impact on all related-party cost sharing agreements. Although cost sharing agreements governed by the 2003 regulations typically have provided for a sharing of stock-based compensation, they often have provided for an adjustment retroactive back to the start of the agreement if there is any relevant change in law. Taxpayers with cost sharing agreements should carefully review their agreements and tax positions to determine whether their agreement provides for an adjustment mechanism or if claims for refund for open years are appropriate based on the *Altera* holding.

In addition, taxpayers should consider whether *Altera* has opened the door for additional regulatory challenges, both in the transfer pricing arena and elsewhere, in contexts where the regulations were premised on Treasury's factual or theoretical assumptions that lack sufficient evidentiary support. The *Altera* case already has been brought to the attention of the district court handling the Microsoft summons litigation in the Western District of Washington as relevant to determining whether the Treasury regulations at issue are valid,[4] and the case will likely also be cited in cases involving the validity of other transfer pricing regulations, such as the regulations currently under review by the Tax Court in *3M Co. et al. v. Commissioner*, No. 005816-13 (T.C. filed Mar. 11, 2013). In addition, the transfer pricing regulations governing services transactions, which were developed following the regulations at issue in *Altera*, also define the term "cost" to include stock-based compensation and therefore may be vulnerable to reasoning similar to that in *Altera*.

Finally, taxpayers and other commentators should consider the Tax Court's reasoning in *Altera* in developing comments to proposed regulations. *Altera* demonstrates that such comments can be important in laying a foundation for future judicial challenge even if the commentators are not successful in persuading Treasury.

1. All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

2. Section 7805(a) instructs the Treasury to “prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.”

3. Importantly, the Tax Court did not address whether Treasury could modify or abandon the arm’s length standard in regulating under section 482 because Treasury expressly had not done so.

4. See Notice of Supplemental Authority, *United States v. Microsoft Corp.*, No. 2:15-cv-00102 RSM (W.D. Wash. Aug. 6, 2015).

For additional information, please contact any of the following lawyers:

Patricia Sweeney, psweeney@milchev.com, 202-626-5926

Alan Horowitz, ahorowitz@milchev.com, 202-626-5839

Andrew Howlett, ahowlett@milchev.com, 202-626-5821
