TAX MANAGEMENT

TRANSFER PRICING

REPORT

Hold the Mayo: Did the Supreme Court Change the Game For Potential Attacks on the U.S. Transfer Pricing Regulations?

The authors assess the impact of the Supreme Court's Mayo Foundation *decision on the Section 482 cost sharing and services regulations, concluding that while the case raises the bar for taxpayers seeking to invalidate IRS regulations, the hurdle remains surmountable.*

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In *Mayo Foundation for Medical Education and Research v. U.S.*, No. 09-837, the U.S. Supreme Court unanimously held that the Treasury Department acted reasonably in promulgating a rule that says medical residents are not exempt from paying employment taxes under the Federal Insurance Contributions Act.[1] In the 8-0 opinion written by Chief Justice John Roberts, the justices deferred to an Internal Revenue Service regulation interpreting the student exemption to FICA, in which the Service said employees normally scheduled to work 40 or more hours per week cannot claim a student exemption.

[1] See 8 BNA *Daily Tax Report* GG-1, 1/12/11.

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The decision unquestionably raises the bar for a frontal assault on Treasury regulations. This article examines the deference standard adopted by the *Mayo* court and holds up both the 2009 final Section 482 services rules[2] and the 2008 temporary cost sharing rules[3] against the prism of that standard.

Chevron Review of Treasury Regulations

The Supreme Court's landmark decision in *Chevron USA Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984), was the starting point for a new branch of administrative law. It told courts that they are not the primary arbiters of congressional intent in construing ambiguous statutory language—not when an agency has promulgated regulations relevant to the controversy. Instead, the court must defer to the agency's statutory interpretation so long as it is reasonable, even

[2] T.D. 9456, 74 Fed. Reg. 38829-38876, 8/4/09, corrected at 74 Fed. Reg. 46345-46347, 9/9/09. See 18 *Transfer Pricing Report* 277, 290, 8/6/09.

[3] T.D. 9441, 74 Fed. Reg. 340-391, 1/5/09, corrected at 74 Fed. Reg. 9570-9572, 3/5/09. See 17 *Transfer Pricing Report* 579, 595, 1/8/09.

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if the court believes that a different interpretation would be better.

The notion that an agency's view of a statute carries considerable weight in court was already a familiar one to tax lawyers. They were accustomed to operating in an environment where Treasury regulations provided detailed rules to flesh out statutes that often used general language and broad concepts. Thus, even prior to *Chevron*, cases such as *U.S. v. Correll*, 389 U.S. 299, 306-07 (1967), and *National Muffler Dealers Ass'n v. U.S.*, 440 U.S. 472 (1979), made clear that courts generally must defer to valid Treasury regulations and apply interpretative guidance embedded in those regulations, rather than examining congressional language and seeking to discern congressional intent in the first instance to fashion their own judicially created rules.

For the past 25 years, two lines of precedent advanced in parallel, with courts developing a new body of law under *Chevron* when deciding whether to defer to regulations outside the tax arena, while invoking *Correll* and *National Muffler* when deciding whether to defer to Treasury regulations in tax cases. More recently, however, some practitioners and courts began to question whether it was appropriate to treat Treasury regulations differently. Why, they asked, should not the *Chevron* deference rules govern tax cases as well?

In most cases this debate was academic. However, precedents were developed in the wake of *Chevron* that discounted the relevance of some factors that *National Muffler* had specifically identified as justifying reduced deference to a Treasury regulation.

Mayo definitively resolved this uncertainty, making the *Chevron* rules fully applicable to Treasury regulations, and thereby making it harder for tax litigants to prevail in the face of a contrary regulation. The Supreme Court was unusually explicit in squashing future resort to arguments that tax lawyers had been making for decades when seeking to avoid the dictates of Treasury regulations. Citing *National Muffler*, Chief Justice Roberts noted that previously ''a court might view an agency's interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved.''

Making it clear that those days are over, he continued, ''Under *Chevron*, in contrast, deference to an agency's interpretation of an ambiguous statute does not turn on such considerations.'' The court hammered home the point, citing post-*Chevron* cases establishing that ''agency consistency'' is irrelevant to the deference analysis and concluding that ''neither antiquity nor contemporaneity with [a] statute is a condition of [a regulation's] validity.'' Importantly from the perspective of the transfer pricing community, the court also found it ''immaterial to [its] analysis that a 'regulation was prompted by litigation.' ''

The court emphasized that the same *Chevron* deference principles apply both to ''legislative'' Treasury regulations promulgated under a specific congressional grant of rulemaking authority and to ''interpretive'' regulations promulgated under Treasury's general rulemaking authority under Section 7805(a). Previously, the court had stated that such ''interpretive'' Treasury regulations were entitled to ''less deference'' than regulations issued under a specific grant of authority.[4]

Mayo surely will make it harder for taxpayers to argue against regulations in certain circumstances. In particular, it strengthens the government's ability to use the regulatory process to prospectively avert the impact of adverse court decisions. But one should not overstate the consequences of *Mayo*. Congress still makes the laws. *Mayo* does not give Treasury *carte blanche* to do whatever it wants by way of regulation. As Judge J. Harvie Wilkinson III of the U.S. Court of Appeals for the Fourth Circuit recently observed in the wake of *Mayo*, ''it remains the case that agencies are not a law unto themselves. No less than any other organ of government, they operate in a system in which the last words in law belong to Congress and the Supreme Court.''[5] Regulations can still be invalidated, but *Mayo* requires taxpayers to frame their challenge within ''the two-part framework announced in *Chevron*.''[6]

The *Chevron* Framework

Step 1 under a *Chevron* framework is to ask whether Congress has directly spoken to the precise question at issue.

''If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress,'' the *Chevron* decision states. If statutory text is unambiguous, then a contrary regulation must fall.

For example, suppose a statute establishes a uniform 5 percent negligence penalty. Treasury issues a regulation that provides for a 10 percent negligence penalty in certain cases. That is an easy case; the regulation is invalid. If the text alone is arguably ambiguous, but there are other strong indicia of congressional intent, then the question is more difficult. *Chevron* itself states that a court can use ''traditional tools of statutory construction'' in determining clear congressional intent at Step 1, but later cases have called into question whether a court should go much beyond the text itself. [7]

If the statute is determined to be ambiguous, then the inquiry moves to Step 2: ''whether the agency's answer is based on a permissible construction of the statute.'' The Step 2 inquiry does not lend itself to bright-line rules. The agency interpretation cannot be ''arbitrary, capricious, or manifestly contrary to the statute''; it has to be ''reasonable.'' ''Reasonableness'' may be assessed in terms of context, purpose, and how the regulation fits

[4] *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982).

[5] *Home Concrete & Supply LLC v. U.S.*, No. 09-2353 (4th Cir. 2/7/11).

[6] The regulations involved in *Mayo* were issued under formal notice-and-comment procedures, thereby clearly implicating *Chevron* deference. Less formal agency pronouncements are not necessarily entitled to such deference. See, generally, *U.S. v. Mead Corp.*, 533 U.S. 218 (2001). Thus, for example, courts might not need to be as deferential to temporary regulations issued without notice-and-comment. At the same time, the court has made clear that notice-and-comment is not an absolute prerequisite to *Chevron* deference. *See Barnhart v. Walton*, 535 U.S. 212, 222 (2002).

[7] See, for example, *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967, 982 (2005) (*Chevron* Step 1 is satisfied when the claimed statutory construction ''follows from the unambiguous terms of the statute'').

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the entire statutory scheme. The inquiry is not confined to whether the regulation reasonably parses the statutory text.[8]

The case law is not entirely monolithic in application of the *Chevron* analysis. To some extent, the two steps may merge into a single inquiry—in some cases, courts have considered whether the regulation is a reasonable interpretation of the statute.

Other cases are more careful to separate the two inquiries. In *Mayo*, for example, the issue before the court turned on the validity of a regulation creating a bright-line rule that no one who worked a 40-hour week could qualify for the ''student'' exemption from FICA regulation—even medical residents who are unquestionably ''students'' in some sense. First, the court held that the regulation hurdled Step 1 scrutiny because the statute did not define ''student'' or address the precise question of whether medical residents are covered. Then the court found that the regulation was ''reasonable,'' observing that it furthered administrative convenience to have a bright-line rule, rather than a case-by-case analysis, and that it was not irrational to conclude that these were the kind of workers Congress intended to be covered by Social Security.

Analysis of transfer pricing regulations implicates both steps of *Chevron*. Section 482 contains broad language that leaves large gaps to be filled in by regulation and assessed at *Chevron* Step 2. But it also contains some foundational precepts embedded in the statutory text that provide genuine constraints on Treasury's authority and, arguably, establish obstacles at Step 1 to extension of the regulatory process to achieve certain outcomes.

The next section examines how some of the most significant recent developments in transfer pricing regulations will look under a *Chevron* microscope.

Internal Revenue Code as Predicate For the Section 482 Regulations

Section 482 provides, in its entirety:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. 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.

Regulations under that section are thus issued under Treasury's general grant of authority, in Section 7805(a), to ''prescribe all needful rules and regulations for the enforcement'' of the Internal Revenue Code. The applicable statute, by its terms, provides two distinct constraints on regulatory authority in the transfer pricing arena:

- regulations should provide for adjustment only where the IRS determines that such adjustment is *necessary in order to prevent evasion of taxes or to clearly reflect income* of commonly controlled entities interacting with each other; and
- in the case of a transfer or license of intangible property (as that term is defined by Section 936(h)(3)(B)), the income realized from such transfer or license shall be *commensurate with the income* attributable to the intangible.

That is all. Accordingly, the Step 1 *Mayo-Chevron* test of a regulation issued under Section 482 is met so long as the regulation does not contravene one of the foregoing constraints. For many transfer pricing regulations, then, the test of validity will be under Step 2—whether the regulation constitutes a reasonable construction of the statute—and the *Mayo* court suggests a fair degree of deference to Treasury expertise in weighing the reasonableness of its actions.

Final Services Regulations

The services regulations represented the culmination of six years of dialogue. In 2003, Treasury issued proposed regulations on the transfer pricing of intercompany services, which had proliferated during the 35 years since the promulgation of Regs. §1.482-2(b), the only real guidance on the books in that area. Comments were received from the taxpayer community, and temporary regulations were issued in 2006 in response to such guidance; those temporary regulations were issued in final form with limited changes in 2009.

While some in the tax community find fault with certain pronouncements in the services regulations, one would be hard-pressed to argue that any of the provisions flunk the Step 1 *Mayo-Chevron* test. The regulatory grant is broad indeed, and it is beyond cavil that the services regulations address a long-overdue need for regulatory guidance in this area. Consequently, taxpayers challenging the services regulations likely would be relegated to the Step 2 inquiry into the reasonableness of Treasury's construction in light of statutory constraints noted above.

The next section analyzes two of the more sensitive regulatory interpretations under the Section 482 services rules.

Controlled Services Transactions

The services provisions at Regs. §1.482-9(l)(1) define a controlled services transaction to include any activity by one member of a controlled group that results in a benefit to one or more other members of the controlled group. Activities that provide only an indirect or remote benefit need not be charged, according to Regs. §1.482-9(l)(3)(ii). Nor are stewardship activities chargeable. For this purpose, stewardship includes ''duplicative activities'' (for example, parental oversight) and ''shareholder activities.'' ''Shareholder activities'' under Regs. §1.482-9(l)(3)(iv) are activities performed by a shareholder *solely* for its own benefit in its capacity as a shareholder.

[8] See, for example, *Whitman v. American Trucking Assns. Inc.*, 531 U.S. 457, 481-86 (2001) (invalidating regulation at *Chevron* Step 2 because it was ''at odds with [the statute's] structure and manifest purpose'').

This definition of "shareholder activities" in the services regulations caused some consternation in the tax community, in part because it represented a departure from the 2003 proposed regulations.[9] That said, it is hard to imagine a court sustaining a challenge to the regulatory construction of a "controlled services transaction" on the grounds that it does not reasonably interpret the statutory mandate. Like the statute under review in *Mayo*, "stewardship" is an area, at least in the transfer pricing context, where Congress has not acted and Treasury's approach is not manifestly arbitrary or capricious.

Total Services Costs

The services provisions at Regs. §1.482-9(j) explicitly define "total services costs," for purposes of providing compensation for a chargeable controlled services transaction, as encompassing "all costs in cash or in kind (including stock-based compensation)." Treasury received numerous comments on the treatment of stock-based compensation when this language appeared in the 2006 temporary regulations. This also was a point of contention in the cost sharing context, and was adjudicated in that context in *Xilinx Inc. v. Comr.*[10] The Tax Court in *Xilinx* observed that taxpayers "are merely required to be compliant, not prescient."

The IRS in the services regulations explicitly provided for the inclusion of stock-based compensation in the total costs identified with providing a service. Still, plenty of room for debate exists as to the manner of accounting for stock-based compensation, and, further, as to the interaction of this aspect of the services provisions with the comparability provisions in the broader section 482 regulations.

However, a frontal attack on this element of the services regulations certainly is made more difficult by the *Mayo* opinion. It would require a taxpayer to demonstrate, notwithstanding FAS 123R[11] and the increasing global adoption of international financial reporting standards for accounting purposes, that a regulation requiring inclusion of stock-based compensation is not a reasonable means for Treasury to employ in order to prevent tax evasion or to ensure that the tax return clearly reflects income.

Adding to the degree of difficulty is the fact that the services cost method, where the intercompany charge is based only on the taxpayer's "total services costs" (and hence not subject to markup and comparability considerations), is an elective method—a *de facto* safe harbor. The regulations do not require taxpayers to elect the services cost method in pricing intercompany services; consequently, imposing a precondition on the election of the method would seem to be a permissible exercise of regulatory authority. The elective nature of the services cost method is perhaps one difference between the stock-based compensation rule in the services regulations and the same rule in the cost sharing regulations. That is, perhaps it cannot be arbitrary and capricious per se for Treasury to provide an elective safe harbor that taxpayers are free to accept or reject. It is less clear that the same argument would hold up when applied to the IRS's cost sharing regime, which Treasury positions not as a safe-harbor election but rather as an extension of the arm's-length standard.

Perhaps the remedy left to taxpayers following *Mayo* is not wholesale invalidation of the stock-based compensation mandate of the services regulations, but rather taking the position that their intercompany services arrangements are nonetheless consistent with the arm's-length standard under general principles.[12]

Temporary Cost Sharing Regulations

Issued as a "litigating" regulation (a point no longer relevant, with *National Muffler* now deceased), the temporary cost sharing provisions at Regs. §1.482-7T reflect a variety of positions taken by the Service that many practitioners would characterize as extreme in the context of prior law and accepted practice under Section 482 and the 1995 cost sharing regulations.

One could argue (and many have) that any regulation not requiring all adjustments under Section 482 to be supported by objective arm's-length transactional data is suspect. Of course, comparable uncontrolled transactions do not always exist, and profit-based methods delineated in Regs. §§1.482-5 and -6 (upon which many transfer pricing analyses are based) do not depend, at least not in any direct sense, on transactional data.

More fundamentally, several other challenges to the temporary regulations spawn from the specific statutory codification of the "commensurate with income" principle. That clause, found in the last sentence of Section 482, was added as part of the Tax Reform Act of 1986 to reflect congressional concerns that intangibles were being undervalued in outbound transfers.

Two-Way Commensurate With Income

Taking on "commensurate with income" directly, it would seem, is Regs. §1.482-7T(i)(1), which provides that the IRS commissioner "may," but need not, "make allocations to adjust the results of a controlled transaction in connection with a [cost sharing arrangement] so that the results are consistent with an arm's length result." Thus, under the temporary regulations, the IRS may choose to forgo adjusting the results of a cost sharing arrangement, even if those results are not arm's-length, simply because such an adjustment would inure to the taxpayer's benefit.

It is hard to see how this one-way street is consistent with the clear mandate of Section 482 that "the income

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[9] For a more complete analysis of the stewardship provisions, see "The New Services Regulations: Stewardship in the Disjunctive," 18 *Transfer Pricing Report* 370, 8/6/09.

[10] 125 T.C. 37 (2005), *aff'd* 598 F.3d 1191 (9th Cir. 2010). See 14 *Transfer Pricing Report* 1161, 1171, 3/25/10

[11] Statement of Financial Accounting Standard No. 123 Revised (FASB, 2004).

[12] Rules issued in 2003 specifically providing for the inclusion of stock-based compensation in cost sharing arrangements state, in part: "[C]ontrolled taxpayers might agree at the outset of an arrangement to determine the compensation of one party based on a subset of that taxpayer's costs . . . . [S]uch an arrangement between controlled taxpayers would not in substance constitute an arrangement to which the rules of §1.482-7 would apply. . . . Rather, such an arrangement should be analyzed under the other section 482 regulations (in particular, sections 1.482-1, 1.482-2(b), and 1.482-4) to determine whether it reaches results consistent with the arm's length standard, and any allocations by the Commissioner should be consistent with such other section 482 regulations." T.D. 9088, 68 Fed. Reg. 51171 (8/26/03). See 12 *Transfer Pricing Report* 350, 398, 9/17/03.

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with respect to such transfer or license *shall* be commensurate with the income attributable to the intangible'' (emphasis added). The Service might well argue that it is not required to audit a taxpayer in order to make a commensurate-with-income adjustment in the taxpayer's favor; however, such an adjustment at least could be required if the Service makes any other Section 482 adjustments.[13] It would seem that taxpayers have a good argument that the Service is bound to follow the commensurate-with-income mandate to ensure that income from the transfer or license of intangible property is commensurate with the income attributable to that intangible.[14]

Investor Model and Useful Life

A variation on this theme is at the heart of the temporary regulations, with the adoption of the so-called investor model and its associated views, explicit and implicit, on the useful life of platform technology contributions to cost sharing arrangements. Under the investor model as set forth in Regs. §1.482-7T(g)(2)(ii)(A), the payment for a platform contribution must be calculated by reference to the prior activities undertaken taken by the cost sharing participants (for example, initial development of the intangibles), which has the likely effect of attributing income from risky post-transfer intangible development activities back to the original intangible contribution. Thus, ''[i]f the cost shared intangibles themselves are reasonably anticipated to contribute to developing other intangibles'' then the cost sharing arrangement should, in perpetuity,[15] route residual income back to the original developer of the intangibles. The investor model and the temporary regulations' premise of infinite useful life[16] arguably are inconsistent with the commensurate-with-income mandate of Section 482.

Although the term ''attributable to'' is broad and susceptible to interpretation via regulatory guidance passing *Mayo-Chevron* scrutiny, the term does have meaning, and that meaning delimits the scope of reasonable regulation. It is hard to understand how income ''attributable to'' post-contribution intangible development activities could reasonably be viewed as ''attributable to'' the transferred intangibles within the meaning of Section 482.[17] Purporting to extend economic useful life of transferred intangibles does not change that immutable fact.[18] Although Treasury certainly has the prerogative to reasonably define what income is and is not attributable to an intangible, the investor model and perpetual life mandates in the temporary regulations deem facts to be true that are empirically untrue. By prescriptively turning economic reality on its head, the temporary regulations may fall short of the Step 2 bar.

The temporary regulations at §1.482-7T(g)(2)(iii)(A) obfuscate this end-run on Section 482, asserting that recharacterization via the investor model merely reflects ''realistic alternatives'' to what the taxpayer did. This ignores the fundamental principle of *Gregory v. Helvering*, 293 U.S. 465, 469 (1935): taxpayers have the ability to structure their affairs as they see fit, as long as the structure has economic substance.[19] Section 482 gives the Secretary the power only to ''distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses''—not to rearrange those affairs in a manner that suits his fancy. Accordingly, the cornerstone of the temporary regulations, the investor model, arguably is not an interpretation of the words ''attributable to'' at all. Stated another way, it could be said to contravene the statutory predicate by disregarding the parties' allocation of development risk under the cost sharing paradigm.

Conclusion

Even before the Supreme Court spoke in *Mayo*, it was an uphill battle to invalidate a duly enacted Treasury regulation. There can be little question that the *Mayo* decision strengthens the Service's hand in defending against regulatory attack. Taxpayers certainly will have to take this change in the landscape into account in evaluating their filing positions and in determining a course of action in resolving thorny tax controversies. But the door remains open for well-crafted arguments—even in the context of Section 482 where the applicable statute provides a relatively broad canvas for Treasury action.

[13] To be clear, the regulations permit affirmative taxpayer use of Section 482 in limited circumstances: (i) when necessary to reflect an arm's-length result when reflected as part of a timely filed return for the year in question (Regs. §1.482-1(a)(3)); and (ii) where a setoff is available (that is, an offset for other transactions found not to be conducted at arm's length between the same controlled taxpayers in the same taxable year).

[14] This argument is particularly compelling in the context of the legislative history of the Tax Reform Act of 1986. See, for example, General Explanation of the Tax Reform Act of 1986 (5/4/87), pp. 1016-1017: ''[T]he objective of these provisions [is] that the division of income between related parties reasonably reflect the relative economic activity undertaken by each.'' Congress directed taxpayers and the Service to use the actual results attributable to the intangible property to determine and evaluate related-party payments. See H.R. Rep. No. 99-426, at p. 425 (1985); General Explanation of the Tax Reform Act of 1986, p. 1014 (1987).

[15] For a further discussion of how the IRS assumption of perpetual life ignores the real world of technology development, see http://appellatetax.com/2010/12/06/the-curious-non-appeal-of-veritas.

[16] The preamble to the temporary regulations allowed for the possibility that if ''the technology is reasonably expected to achieve an incremental improvement in results for only a finite period . . . [t]he period of enhanced results that justifies the platform investment in such circumstances effectively would correspond to a finite, not a perpetual, life.'' Unfortunately, language reflecting this possibility does not appear to the naked eye to have made its way into the text of the temporary regulations.

[17] See *Veritas Software Corp. v. Comr.*, 133 T.C. 297, at pp. 323-324 (2009).

[18] *Id*. at pp. 324-327.

[19] See *Bausch & Lomb Inc. v. Comr.*, 92 T.C. 525, 583 (1989), *aff'd* 933 F.2d 1084 (2d Cir. 1991): ''Although it is possible that B&L could have established the Irish facility in a manner which resulted in a greater United States tax, it is axiomatic that a taxpayer is not obligated to arrange his affairs in a manner which maximizes his tax burden.''