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Global Tax Alert

News from Transfer Pricing

US Ninth Circuit panel reverses Tax Court opinion in *Altera*, holding stock-based compensation to be a compensable cost under IRC Section 482

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On 7 June 2019, in a 2-1 ruling, a Ninth Circuit panel reversed the Tax Court's holding in *Altera v. Comm'r*, 145 T.C. 91 (2015), and upheld a 2003 regulation that requires participants in a cost-sharing arrangement (CSA) to share stock-based compensation costs (SBC costs).[1] The Ninth Circuit panel concluded that the 2003 regulations were valid under the *Administrative Procedure Act* (APA). The Ninth Circuit panel held that, "[i]n sum, we disagree with the Tax Court that the 2003 regulations are arbitrary and capricious under the standard of review imposed by the APA. While the rulemaking process was less than ideal, the APA does not require perfection."

The ruling was the second time the Ninth Circuit had reversed the Tax Court's opinion. The Ninth Circuit heard the case for the second time after withdrawing its initial opinion, in which Judges Sidney R. Thomas and Stephen R. Reinhardt voted to reverse the Tax Court's 2015 decision, due to the death of Judge Reinhardt. In this second opinion, Judge Susan P. Graber, replacing Judge Reinhardt, voted with Judge Thomas to reverse the Tax Court's decision.

Detailed discussion

Under a CSA, intangible development costs (IDCs) are shared. Before the Tax Court, the taxpayer argued that the 2003 version of Treas. Reg. Section 1.482-7(d)(2), which required SBC costs to be included in IDCs, was invalid. The taxpayer argued that the Internal Revenue Service (IRS) did not follow the APA requirements when the regulation was adopted.

In a fully reviewed opinion issued on 27 July 2015, the Tax Court agreed with the taxpayer's position, noting that the question of whether the inclusion of such costs is consistent with the arm's-length standard is an empirical determination. Because commentators had provided significant evidence that unrelated parties, acting at arm's length, would never agree to share each other's SBC costs, the Tax Court concluded that a final rule requiring related parties to share SBC costs "lack[ed] a basis in fact." Noting that "Treasury failed to rationally connect the choice it made with the facts found, Treasury failed to respond to significant comments when it issued the final rule, and Treasury's conclusion that the final rule is consistent with the arm's-length standard is contrary to all the evidence before it," the Court concluded that "the final rule … is invalid."[2]

The Government appealed the Tax Court's decision. On 24 July 2018, the Ninth Circuit reversed the Tax Court in a 2-1 decision, holding that "the challenged regulations are not arbitrary and capricious but rather a reasonable execution of the authority delegated by Congress to Treasury."[3] After withdrawing the opinion due to the death of Judge Reinhardt, the Ninth Circuit reheard the case and issued its opinion on 7 June 2019.

Chevron

After reviewing the legislative history and the history of the 2003 regulation, the first issue that the Ninth Circuit panel considered in the 7 June 2019 opinion was whether the Tax Court correctly applied the *Chevron*[4] standard in examining the agency's interpretation of the statute that defines the scope of its authority.

The opinion notes that the first step under *Chevron* is for the Ninth Circuit panel to "apply the traditional rules of statutory construction to determine whether 'Congress has directly spoken to the precise question at issue.'"[5] Under *Chevron*, the Ninth Circuit panel determined that:

> [IRC][6] Section 482 does not speak directly to whether the Commissioner may require parties to a QCSA to share employee stock compensation costs in order to receive the tax benefits associated with entering into a QCSA. Thus, there is no question that the statute remains ambiguous regarding the method by which Treasury is to make allocations based on [SBC costs].

The Ninth Circuit panel then addressed the second step in the *Chevron* analysis by "consider[ing] whether Treasury's interpretation of [IRC Section] 482 as to allocation of employee stock option costs is permissible." The Ninth Circuit panel noted that the 1986 Amendments added the commensurate-with-income standard for any transfer (or license) of intangible property. The Ninth Circuit panel states that:

> [the commensurate-with-income standard] is a purely internal one, that is, internal to the entity being taxed, and evidence supports Treasury's belief that Congress intended it to be. H.R. REP. NO. 99-426, at 423-35; H.R. REP. NO. 99-841, at II-637 (Conf. Rep.). In the QCSA context, Congress did not want to interfere with controlled [cost-sharing] arrangements, but only to the degree that the allocation of costs and income 'reasonably reflect[s] the actual economic activity undertaken by each.' H.R. REP. No. 99-841, at II-638 (Conf. Rep.).

As a result, the Ninth Circuit panel concluded that Treasury's decision to forego the comparability analysis and apply the commensurate-with-income standard was reasonable, noting that:

> Treasury reasonably interpreted [IRC Section] 482 as an authorization to require internal allocation methods in the QCSA context, provided that the costs and income allocated are proportionate to the economic activity of the related parties. These internal allocation methods are reasonable methods for reaching the [arm's-length] results required by statute.

Accordingly, the Ninth Circuit panel concluded Treasury's interpretation of the regulations was acceptable under *Chevron*.

APA

The second issue that the Ninth Circuit panel considered was whether the procedures used by Treasury when applying the 2003 regulation were valid under the APA. Under *State Farm*, when a rule is "promulgated in a procedurally defective manner, it will be set aside regardless of whether its interpretation of the statute is reasonable."[7]

The APA directs courts to interpret statutory provisions and evaluate the agency's procedural decisions to determine the meaning or application of the terms. Under the APA, agencies may not act in ways that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[8]

The Ninth Circuit panel noted that the APA prescribes a three-step process for evaluating the procedure used to promulgate "notice-and-comment rules."

> First, a '[g]eneral notice of proposed rulemaking' must ordinarily be published in the Federal Register. 5 U.S.C. Section 553(b). Second, provided that 'notice is required,' the agency must 'give interested persons an opportunity to participate in the [rule-making] through submission of written data, views, or arguments'. *Id*. Section 553(c). … Third, the agency must incorporate in the final rule 'a concise general statement of [its] basis and purpose.' 5 U.S.C. 553(c).

The Ninth Circuit panel characterized the taxpayer as arguing that Treasury failed the second step. The taxpayer had argued that, although Treasury solicited public comments on the proposed regulations, Treasury did not adequately respond to those comments, rendering the regulations arbitrary and capricious. However, the Ninth Circuit panel concluded that:

> Treasury gave sufficient notice of what it intended to do and why, and the submitted comments were irrelevant to the issues Treasury was considering. Because the comments had no bearing on 'relevant factors' to the rulemaking, nor any bearing on the final rule, there was no APA violation.[9]

Dissent

One judge on the Ninth Circuit panel dissented from the majority decision. The judge would have found, as the Tax Court did, that the 2003 regulations are invalid, and Treasury's application was "arbitrary and capricious." Specifically, the judge stated:

> I would instead find, as the Tax Court did, that Treasury's explanation of its rule (to the extent any was provided) failed to satisfy the *State Farm* standard, 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, and that its new rule is invalid as arbitrary and capricious.

The judge noted that Treasury should be bound by its initial explanation of the regulations because the Ninth Circuit panel cannot accept Treasury's invitation to "recreate the record and interpret [IRC Section] 482 in a way it never asked the Tax Court to do in order to supply a post-hoc justification for its [decision-making]." Instead, the judge concludes that Treasury's "belated arguments are insufficient to justify the 2003 regulations and that those regulations are … procedurally invalid."

Next steps

Following the issuance of the 7 June 2019 opinion, the taxpayer has 45 days to apply for either or both a panel rehearing or a rehearing "en banc" by the full Ninth Circuit Court of Appeals. Alternatively, the taxpayer has 90 days to apply for a writ of certiorari to the Supreme Court. If the Ninth Circuit denies the rehearing requests, then the 90-day window for the taxpayer to apply for certiorari to the Supreme Court resets from the date the Ninth Circuit publicly rejects the taxpayer's rehearing request.

Endnotes

1. A CSA that fully complies with the applicable regulations (as written in 2003) is referenced throughout this Alert as a qualified cost-sharing arrangement (QCSA).
2. *Altera v. Comm'r*, 145 T.C. 91, 120 (2015).
3. *Altera v. Comm'r*, Nos. 16-70496, 16-70497 (filed 24 July 2018).
4. *Chevron, U.S.A., Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).
5. *Altera v. Comm'r*, Nos. 16-70496 and 16-70497 (7 June 2019) quoting *Chevron, U.S.A., Inc., v. Natural Resources Defense Council, Inc.* 467 U.S. 837, 842 (1984).
6. Internal Revenue Code.
7. *Altera Corp. v. Comm'r*, Nos. 16-70496 and 16-70497 (7 June 2019) quoting *Catskill Mountains Chapter of Trout Unlimited, Inc. v. EPA*, 846 F.3d. 492, 522 (2d Cir. 20176).
8. 5 U.S.C. Section 706(2)(A).
9. *Altera Corp. v. Comm'r*, Nos. 16-70496 and 16-70497 (7 June 2019) quoting *Am. Mining Cong. v. U.S. EPA*, 965 F.2d 759, 771 (9th Cir. 1992).

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