November 15, 2019

Ninth Circuit Denies Altera's Petition for Rehearing

After the Ninth Circuit Held Against Altera, the Ninth Circuit Denies Altera's Petition for Rehearing *En Banc*

SUMMARY

On November 12, 2019, in *Altera Corporation* v. *Commissioner*,[1] the U.S. Court of Appeals for the Ninth Circuit denied Altera's petition for rehearing *en banc*[2] of its case (the "Rehearing Decision"), following the Ninth Circuit's decision against Altera issued on June 7, 2019 (the "2019 Opinion").[3] The 2019 Opinion reversed a U.S. Tax Court ruling (the "Tax Court Decision")[4] and deferred to the U.S. Treasury's interpretation of Section 482 of the Internal Revenue Code stating that U.S. corporations must allocate to their non-U.S. affiliates a portion of the cost of stock-based compensation for employees to the extent the work of such employees is for the benefit of the corporations' non-U.S. affiliates pursuant to what is referred to as "qualified cost sharing arrangements" ("QCSAs").

BACKGROUND

A. SECTION 482

Section 482 and related Treasury regulations authorize the Internal Revenue Service ("IRS") to allocate income and expenses among related entities to prevent corporations from shifting income and expenses through intercompany transactions in order to minimize overall tax liability.[5] In the absence of Section 482, a taxpayer could artificially move income to a low-tax jurisdiction or allocate costs to reduce its tax liability in a high-tax jurisdiction. To determine the true taxable income of related parties, Treasury Regulations under Section 482 adopted the arm's-length standard, which examines whether the results of a transaction among related parties are consistent with the results that would have been realized if unrelated taxpayers had engaged in the same transaction under the same circumstances. In 1986, Congress amended

Section 482 to require that the income with respect to any transfer or license of intangible property "be commensurate with the income attributable to the intangible," with the intent that this "commensurate with income standard" would address situations where there are no comparable unrelated party transactions.[6]

Both the Tax Court and Ninth Circuit had held in *Xilinx Inc.* v. *Commissioner* that, under the then-relevant Treasury regulations, parties to QCSAs did not need to share stock-based compensation costs, because, applying the arm's-length standard, unrelated parties would not agree to share such costs.[7]

Following *Xilinx* and after the administrative rulemaking process at issue in Altera,[8] Treasury issued final Treasury regulations (the "2003 Treasury Regulations") that explicitly required parties to QCSAs to share stock-based compensation costs and provided that a QCSA produces an arm's-length result only if the parties' costs are determined in accordance with this final rule (the "SBC Rule").[9] Altera challenged these 2003 Treasury Regulations under the Administrative Procedure Act ("APA")[10] and the two-step test enunciated by the Supreme Court decision in *Chevron*.[11]

B. THE *ALTERA* CASE IN THE TAX COURT AND ITS IMPACT

During each of the 2004–2007 taxable years, Altera (a computer chip manufacturer incorporated in Delaware) granted stock-based compensation to certain of its U.S. employees who performed research and development activities subject to a cost-sharing agreement with Altera's Cayman Islands subsidiary. Costs related to stock-based compensation were borne entirely by Altera's U.S. entity and were not shared by the Cayman Islands subsidiary. With all stock-based compensation costs allocated to Altera in the U.S., Altera could deduct such costs in order to decrease the amount of income subject to U.S. corporate income tax at the then-applicable rate of 35%.[12]

The IRS issued notices of deficiency to Altera, allocating income from the Cayman Islands subsidiary to Altera pursuant to Section 482. Altera and the IRS filed cross-motions for partial summary judgment on the issue of whether the SBC Rule is arbitrary and capricious and therefore invalid. In 2015, the Tax Court held that the SBC Rule was invalid under the APA because Treasury had engaged in arbitrary and capricious rulemaking, as Treasury's actions were not grounded in fact and expert opinions and Treasury failed to respond to public comments that unrelated parties do not and would not share stock-based compensation costs.[13] The Tax Court Decision was reviewed and agreed by 14 Tax Court judges. The IRS appealed the Tax Court Decision to the Ninth Circuit.

While the IRS' appeal was pending, companies acted in reliance on the Tax Court Decision not to share stock-based compensation costs in QCSAs. In public filings, dozens of companies referred to positions taken in connection with the Tax Court Decision, with billions of dollars in aggregate recorded in tax benefits.

C. THE NINTH CIRCUIT'S 2018 OPINION

On July 24, 2018, the Ninth Circuit issued its opinion (the "2018 opinion"),[14] which reversed the Tax Court Decision and determined, in a two-to-one decision, that Treasury complied with the APA and did not engage in arbitrary and capricious rulemaking on the basis that (i) Treasury provided the public with sufficient notice of what the agency proposed to do and an opportunity to respond to its proposal; (ii) Treasury adequately considered public comments and dismissed those comments; (iii) Treasury's litigation position is not inconsistent with its statements during the rulemaking process; (iv) treating employee stock compensation as costs in the SBC Rule is sufficiently supported by the rulemaking record; and (v) the 2003 Treasury Regulations do not represent a policy change that would alter this conclusion. Furthermore, the Ninth Circuit majority opinion in the 2018 Opinion concluded that Treasury's interpretation of Section 482 in the 2003 Treasury Regulations was entitled to *Chevron* deference, because (i) Congress was silent on sharing employee compensation costs in the statute and intended to give Treasury flexibility under Section 482 to enact rules that will properly allocate cost and income between related parties; and (ii) Treasury's interpretation of Section 482, in light of Congress' intent, is a permissible construction of the statute.[15]

D. WITHDRAWAL OF THE 2018 OPINION

On August 7, 2018, the Ninth Circuit withdrew the 2018 Opinion to allow a reconstituted panel to confer on the decision. The withdrawal of the 2018 Opinion was necessitated by the fact that Judge Stephen Reinhardt, who was ostensibly a member of the majority in the two-to-one decision written by Chief Judge Sidney R. Thomas, had been deceased for over three months before the decision was issued. The lack of two living judges in the majority called the validity of the 2018 Opinion into serious doubt.

E. THE NINTH CIRCUIT'S 2019 OPINION

On June 7, 2019, the Ninth Circuit issued the 2019 Opinion[16] in a two-to-one decision, in which the newly added Judge Graber joined Chief Judge Thomas' opinion. The majority decision in the 2019 Opinion was substantially similar to the majority decision in the 2018 Opinion with respect to the two substantive issues, and again held that (i) the 2003 Treasury Regulations are not arbitrary and capricious under the standard of review imposed by the APA; and (ii) Treasury's interpretation of Section 482 in the 2003 Treasury Regulations was entitled to *Chevron* deference.[17]

Though substantially similar to the majority decision in the 2018 Opinion, the majority decision in the 2019 Opinion is slightly more favorable to the government. First, the majority decision in the 2019 Opinion expressly held that a QCSA is considered a "transfer" for purposes of Section 482.[18] As described above, Section 482 requires that the income with respect to any *transfer* of intangible property "be commensurate with the income attributable to the intangible."[19] Altera argued that the *Chevron*'s first test is not satisfied because Section 482, by its terms, cannot apply to stock-based compensation as there is no "transfer." The majority decision rejected this argument, which means that the majority did not think that Treasury exceeded the delegation of authority apparent from the plain text of Section 482 when Treasury published

the 2003 Treasury Regulations. Second, the majority decision in the 2019 Opinion may be viewed as taking one step forward in its deferential approach to reviewing Treasury interpretations under the APA, compared with the majority decision in the 2018 Opinion, by providing that, "[w]hile the rulemaking process was less than ideal, the APA does not require perfection."[20]

THE REHEARING PETITION

On July 22, 2019, Altera petitioned the Ninth Circuit for rehearing *en banc* (the "Rehearing Petition") basing the Rehearing Petition on the following grounds:

(i) **The 2019 Opinion upsets settled principles of tax law**. Altera criticized the IRS' abandonment of the long-standing and settled arm's-length standard in favor of the commensurate with income standard, which Altera argues is a new and "purely internal" standard which was made up for litigation and was never explained, or even mentioned, during the rulemaking process.

(ii) **The 2019 Opinion validates bad rulemaking**. Altera argued that the 2019 Opinion turned the APA on its head by allowing the IRS to assess billions of dollars in taxes based on reasoning that appeared nowhere in the administrative record and thus was never subject to public scrutiny. Altera further argued that applying *Chevron* deference cannot cure the deficiencies in the rulemaking record, because *Chevron* deference is not available when a regulation is "procedurally defective."

(iii) **The 2019 Opinion is irreconcilable with *Xilinx* and prevents uniform application of the tax laws**. Altera argued that the 2019 Opinion stands in stark contrast to the Ninth Circuit's prior decision in *Xilinx*, creating an intra-circuit conflict. Additionally, Altera argued that the Tax Court, which has national jurisdiction, is not bound by the 2019 Opinion in cases outside the Ninth Circuit's jurisdiction. Therefore, Altera argued, in similar cases residing in the jurisdiction of other circuits, the Tax Court would undoubtedly apply the unanimous Tax Court Decision, resulting in different treatment for taxpayers simply because of geography.

(iv) **The stock-based compensation issue is exceptionally important**. Altera argued that the question at hand (whether related parties must share stock-based compensation) is an important and recurring issue which affects a wide range of companies across the United States and across various industries, and the dollar amounts involved are enormous.

Altera's Rehearing Petition was later supported by several amicus briefs, including briefs filed by Xilinx Inc.,[21] high-tech and software industry groups,[22] a group of former tax officials of foreign jurisdictions (arguing that the IRS' approach—validated by the 2019 Opinion—significantly departs from the common worldwide understanding of what the arm's-length standard means and threatens international coordination and comity),[23] three of the Big-Four accounting firms,[24] and the U.S. Chamber of Commerce (arguing that the 2019 Opinion introduces great uncertainty for the business community and risks undermining the

national economy).[25] Interestingly, one amicus brief, submitted by a group of 29 U.S. law professors, opposed the Rehearing Petition, arguing that (i) the 2003 Treasury Regulations and the 2019 Opinion are entirely consistent with long-standing precedents, practices and understandings regarding the meaning of the arm's-length standard; and (ii) reversal of the U.S. Tax Court by a Court of Appeals is an ordinary occurrence that reflects the federal courts' hierarchy and is not a basis for granting *en banc* review.[26]

THE REHEARING DECISION

On November 12, 2019, the Ninth Circuit denied the Rehearing Petition. Whereas the denial decision was succinct and was not accompanied by any statement from any of the majority judges, Judge M. Smith—joined by Judge Callahan and Judge Base—issued a strong dissent statement with respect to the denial of the Rehearing Petition.

In his dissenting statement, Judge Smith agreed with the Tax Court's unanimous conclusion that Treasury's implementation of the 2003 Treasury Regulations constituted arbitrary and capricious rulemaking in violation of the APA. Judge Smith observed that, in addition to being wrongly decided, the majority's decision engenders deleterious practical consequences, threatens the uniform enforcement of the Internal Revenue Code, invites an effective circuit split, ignores the reasonable reliance of businesses on the well-settled arm's-length standard and subjects those businesses to double taxation, lowers the bar for compliance with the APA, and sends a signal that executive agencies can bypass proper notice-and-comment procedures through post-hoc rationalization.

IMPLICATIONS OF THE 2019 OPINION AND THE REHEARING DECISION

The Ninth Circuit's majority decision in the 2019 Opinion confirmed that stock-based compensation costs must be shared under QCSAs and, significantly, shows a deferential approach to reviewing Treasury interpretations under the APA. By denying Altera's petition for rehearing *en banc*, the Ninth Circuit effectively reconfirmed the 2019 Opinion.

Treasury regulations continue to be challenged under the APA in other Circuit Courts. Significantly, a decision from a federal district court in Texas, *Chamber of Commerce of the United States of America* v. *IRS*,[27] found that temporary anti-inversion regulations under Section 7874 issued by Treasury that were immediately effective violated the APA by failing to give time for public comments. The decision requires that temporary Treasury regulations comply with the APA's notice and comment process.[28] Additionally, in July 2018, the United States Court of Appeals for the District of Columbia Circuit in *Good Fortune Shipping SA* v. *Commissioner*[29] struck down Treasury regulations relating to shipping income (which Treasury regulations had already been amended to rectify the offending provisions post-tax years at issue) under the second step of the *Chevron* analysis. The D.C. Circuit found that the Treasury regulations at issue were an unreasonable interpretation of the statute. Much of the D.C. Circuit's analysis focused on Treasury's failure to justify the position Treasury took in the Treasury regulations (in terms of both explanation and empirical

documentation) and Treasury's failure to explain a change in policy.[30] Thus, challenging Treasury regulations on the basis of the APA and *Chevron* deference continues to be an area in flux that requires close monitoring.

Additionally, the 2019 Opinion, followed by the Rehearing Decision, imposes real costs on companies that, acting in reliance on the Tax Court's invalidation of the SBC Rule, did not share stock-based compensation costs as required under the SBC Rule and/or expected tax benefits due to the SBC Rule's invalidation. The effect will likely be particularly great on technology and pharmaceutical companies that may have allocated fewer expenses than required by the SBC Rule to offshore affiliates, resulting in larger deductions for such stock-based compensation expenses against U.S. income and thereby decreasing U.S. corporate income tax liability.

Furthermore, as provided in the Rehearing Decision's dissent statement, courts outside of the Ninth Circuit's jurisdiction may be persuaded by the uncommon unanimous Tax Court Decision. If so, the tax treatment of stock-based compensation costs could turn on the happenstance of where a business is located and create incentives to locate or incorporate outside of the Ninth Circuit's jurisdiction.[31]

Finally, given the potentially material costs of this decision to some companies, other litigants may come forward to challenge the SBC Rule in another Circuit Court or, perhaps, Altera may petition for certiorari with the Supreme Court, likely emphasizing the strong dissent statement issued by the three Ninth Circuit judges.

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ENDNOTES

1 *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496 & 16-70497, 2019 WL 5884201 (9th Cir., November 12, 2019).

2 En banc hearing means a session in which a case is heard before all the judges of a specific court.

3 *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496, 2019 WL 2400999 (9th Cir. June 7, 2019). For additional information on the 2019 Opinion, see our Client Memorandum, *Ninth Circuit Reaffirms Validity of Treasury Regulations on Cost-Sharing Arrangements*, dated June 20, 2019, *available at* https://www.sullcrom.com/files/upload/SC-Publication-Ninth-Circuit-Reaffirms-Validity-of-Treasury-Regulations-on-Cost-Sharing-Arrangements.pdf.

4 For additional information on the Tax Court Decision, see our Client Memorandum, *Tax Court Invalidates Treasury Regulation on Cost-Sharing Arrangements*, dated July 31, 2015, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Tax_Court_Invalidates_Treasury_Regulation_on_Cost_Sharing_Arrangements.pdf.

5 For additional information see "Background—Section 482" in our Client Memorandum, *Ninth Circuit Reverses Tax Court, Upholds Treasury Regulation on Cost-Sharing Arrangements*, dated August 6, 2018, *available at* https://www.sullcrom.com/files/upload/SC-Publication-Ninth-Circuit-Upholds-Treasury-Regulation-on-Cost-Sharing-Arrangements.pdf.

6 Tax Reform Act of 1986, P.L. 99-514, sec. 1231(e)(1); H.R. REP. NO. 99-246, at 423-24 (1985).

7 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). The Ninth Circuit had initially reversed the Tax Court in *Xilinx*, but later withdrew that opinion.

8 For additional information on the rulemaking process, see our Client Memorandum cited in *supra* note 5, under "Ninth Circuit Decision."

9 Treasury Regulation Section 1.482-7(d)(2) (2003). Later-enacted Regulations under Section 482 have changed the location of the SBC Rule within Treasury Regulations Section 1.482-7. The SBC Rule is reflected in Treasury Regulation Section 1.482-7(d)(1)(iii) in the Regulations currently in force.

10 For explanation on the review of agency action under the APA, see our Client Memorandum cited in *supra* note 5, under "Background—Review of Agency Action Under the APA."

11 *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.* (467 U.S. 837 (1984)). For additional details on *Chevron*, see our Client Memorandum cited in *supra* note 5, under "Ninth Circuit Decision."

12 For additional details, see our Client Memorandum cited in *supra* note 5, under "The Altera Case in the Tax Court and Its Impact."

13 145 T.C. 91 (2015). For additional information on the Tax Court Decision, see our Client Memorandum cited in *supra* note 4.

14 2018 WL 3542989 (9th Cir. 2018). For additional information about the 2018 Opinion, see our Client Memorandum cited in *supra* note 5.

15 For additional details on the Ninth Circuit majority reasoning in the 2018 Opinion, see our Client Memorandum cited in *supra* note 5, under "Ninth Circuit Decision."

16 See *supra* note 3.

17 Interestingly, the majority decision in the 2018 Opinion analyzed the APA compliance first and the *Chevron* deference second, stating that only if Treasury complies with the APA, the court may defer to *Chevron* interpretation (2018 Opinion, *supra* note 14, at *10). On the other hand, the majority decision in the 2019 Opinion analyzed *Chevron* deference first and APA compliance second without reference to the required order of analysis (2019 Opinion, *supra* note 3, starting at 24).

18 2019 Opinion, *supra* note 3, at 25–26.

ENDNOTES (CONTINUED)

19 See "Background—Section 482."

20 2019 Opinion, *supra* note 3, at 49.

21 Brief of Xilinx Inc. as Amicus Curiae Supporting Altera's Petition for En Banc Rehearing, *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496 & 16-70497 (9th Cir., July 31, 2019).

22 Brief of National Association of Manufacturers et al. as Amici Curiae in Support of Appellee's Petition for Rehearing En Banc, *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496 & 16-70497 (9th Cir., August 1, 2019).

23 Brief of Former Foreign Tax Officials as Amici Curiae in Support of the Petition for Rehearing En Banc, *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496 & 16-70497 (9th Cir., August 1, 2019).

24 Brief of Price Waterhouse and Coopers LLP et al. as Amici Curiae in Support of Appellee's Petition for Rehearing En Banc, *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496 & 16-70497 (9th Cir., August 1, 2019).

25 Brief of The Chamber of Commerce of the United States of America as Amicus Curiae in Support of Rehearing En Banc, *Altera Corp. & Subsidiaries v. Comm'r of Internal Revenue, No. 16-70496 & 16-70497 (9th Cir., August 1, 2019).*

26 Brief of Law Academics and Professors as Amici Curiae in Opposition to the Petition for Rehearing En Banc, *Altera Corp. & Subsidiaries v. Comm'r of Internal Revenue, No. 16-70496 & 16-70497 (9th Cir., September 6, 2019).*

27 2017 WL 4682050 (W.D. Tex. 2017). The rule at issue in this case was simultaneously issued as both a temporary regulation, which was immediately effective, and a proposed regulation, which was subject to notice and comment. The district court only considered whether the rule as a temporary regulation violated the notice and comment requirements of the APA.

28 The government has filed an appeal of that decision to the Fifth Circuit, but the appeal was subsequently dismissed at the government's request, after the government finalized the anti-inversion regulations under Section 7874 in July 2018. See *Chamber of Commerce of United States* v. *Internal Revenue Serv.*, No. 17-51063, 2018 WL 3946143 (5th Cir., July 26, 2018).

29 2018 WL 3595945 (D.C. Cir., 2018).

30 *Id*. at *5–7.

31 Rehearing Decision, *supra* 1, at 26.

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