June 20, 2019

Ninth Circuit Reaffirms Validity of Treasury Regulations on Cost-Sharing Arrangements

After New Judge Joins the Panel, the Ninth Circuit Again Reverses the Tax Court Decision in *Altera*

SUMMARY

On June 7, 2019, in *Altera Corporation* v. *Commissioner*,[1] the U.S. Court of Appeals for the Ninth Circuit, in a two-to-one decision (the "2019 Opinion"), reversed a U.S. Tax Court ruling[2] and deferred to the U.S. Treasury's interpretation of Section 482 of the Internal Revenue Code stating that U.S. corporations must allocate a portion of the cost of stock-based compensation for employees to the extent those employees' work is for the benefit of the corporations' non-U.S. affiliates pursuant to what is referred to as "qualified cost sharing arrangements" ("QCSAs").

The 2019 Opinion is substantially similar to the Ninth Circuit decision issued on July 24, 2018 (the "2018 Opinion"),[3] which was withdrawn on August 7, 2018 to allow a reconstituted panel to confer on the decision because Judge Stephen Reinhardt, who was ostensibly a member of the majority in the 2018 Opinion, had been deceased for over three months before the 2018 Opinion was issued.[4]

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")[9] 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"). 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 2004–07 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 opinion was reviewed and agreed by fourteen Tax Court judges. The IRS appealed the Tax Court decision to the Ninth Circuit.

While the IRS's appeal was pending, companies acted in reliance on the Tax Court's decision in *Altera* to not share stock-based compensation costs in QCSAs. In public filings, dozens of companies referred to positions taken in connection with the Tax Court's *Altera* 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 the 2018 Opinion, which reversed the Tax Court's 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's intent, is a permissible construction of the statute.[14]

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.

THE NINTH CIRCUIT'S 2019 OPINION

On June 7, 2019, the Ninth Circuit issued the 2019 Opinion[15] 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 (the majority decision concluded that "Treasury understood Section 482 to authorize it to employ a purely internal, commensurate with income approach where comparable transactions are not comparable"[16]); and (ii) Treasury's interpretation of Section 482 in the 2003 Treasury Regulations was entitled to *Chevron* deference. In light of Section 482's plain text and the legislative history, the majority decision found that Treasury reasonably concluded that Congress intended to hone the definition of the arm's length standard so that it could work to achieve an arm's length result, instead of forcing application of a particular comparability method. Given the long history of the application of other methods, and the text and legislative history of the Tax Reform Act of 1984,

Treasury's understanding of its power to use methodologies other than a pure transactional comparability analysis was reasonable.[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]

Judge O'Malley, who dissented in the 2018 Opinion, dissented in the 2019 Opinion as well, substantially on the same grounds. Generally, the dissenting opinion provided that (i) Treasury failed to comply with the APA; (ii) even if Treasury did not err procedurally, the 2003 Treasury Regulations do not satisfy the second step of the *Chevron* test because Treasury departed from the comparability analysis under the arm's length standard and failed to provide a reasoned explanation for why the commensurate with income standard is permissible under Section 482; (iii) because the 2003 Treasury Regulations were invalid, the Ninth Circuit's decision in *Xilinx*[21] controls; and (iv) even if *Xilinx* did not control, because the 2003 Treasury Regulations are not accorded any deference due to procedural and substantive defects, the correct interpretation of a plain reading of Section 482 is that QCSAs are not "transfers" subject to the "commensurate with income" standard under Section 482.

IMPLICATIONS OF THE 2019 OPINION

The Ninth Circuit majority decision in the 2019 Opinion confirms that stock-based compensation costs must be shared under QCSAs and, significantly, shows a deferential approach to reviewing Treasury interpretations under the APA.

The deferential approach adopted by the Ninth Circuit majority decision in the 2019 Opinion could also affect other transfer pricing cases that are currently being litigated.

Furthermore, 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*,[22] 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.[23] Additionally, in July 2018, the United States Court of Appeals for the District of Columbia Circuit in *Good Fortune Shipping SA v. Commissioner*[24] 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.[25] 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 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.[26]

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 request a rehearing of the case by an expanded panel of the Ninth Circuit judges (also known as rehearing *en banc*) or petition the Supreme Court for review.

* * *

ENDNOTES

[1] *Altera Corp. & Subsidiaries* v. *Comm'r of Internal Revenue*, No. 16-70496, 2019 WL 2400999 (9th Cir. June 7, 2019).

[2] For additional information on the Tax Court's decision in *Altera*, 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.

[3] 2018 WL 3542989 (9th Cir. 2018). For additional information on the 2018 Opinion, see 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.

[4] *Altera Corporation v. Commissioner*, 898 F. 3d 1266, August 7, 2018. For additional information on the withdrawal decision, see our Client Memorandum *Ninth Circuit Withdraws Altera Opinion Reversing Tax Court on Cost-Sharing Arrangements*, dated August 7, 2018, *available at* https://www.sullcrom.com/files/upload/SC-Publication-Ninth-Circuit-Withdraws-Altera-Opinion.pdf.

[5] For additional information see our Client Memorandum cited in *supra* note 3, under "Background—Section 482."

[6] Tax Reform Act of 1986, P.L. 99-514, sec. 1231(e)(1); H.R. REP. NO. 99-246, at 423-24 (1985) ("The committee is concerned that the provisions of sections 482 . . . that allocate income to a U.S. transferor of intangibles may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations. . . . A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables.").

[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 3, 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 3, 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 3, under "Ninth Circuit Decision."

[12] For additional details see our Client Memorandum cited in *supra* note 3, under "The Altera Case in the Tax Court and Its Impact."

[13] 145 T.C. 91 (2015). For additional information on the Tax Court's decision, see our Client Memorandum cited in *supra* note 2.

[14] For additional details on the Ninth Circuit majority reasoning in the 2018 Opinion, see our Client Memorandum cited in *supra* note 3, under "Ninth Circuit Decision."

[15] See *supra* note 1.

[16] 2019 Opinion, *supra* note 1, at 49.

ENDNOTES (CONTINUED)

17 Interestingly, the majority decision in the 2018 Opinion analyzed the APA compliance first and the *Chevron* deference second, stating that only if the Treasury complied with the APA, the court may defer to *Chevron* interpretation (2018 Opinion, *supra* note 3, 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 1, starting at 24).

18 2019 Opinion, *supra* note 1, at 25–26 ("When parties enter into a QCSA, they are *transferring* future distribution rights to intangibles, albeit intangibles that have yet to be developed. Indeed, the present-day transfer of those rights provides the main incentive for entering into a QCSA. The right to distribute intangibles to be developed later is, itself, one right in the bundle of property rights that exists at the time that parties enter into a QCSA.").

19 See "Background—Section 482".

20 2019 Opinion, *supra* note 1, at 49.

21 See *supra* note 7.

22 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.

23 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).

24 2018 WL 3595945 (D.C. Cir. 2018).

25 *Id*. at *5-7.

26 For additional details on tax implications of companies which relied on the Tax Court decision, including aspects of the Tax Cuts and Jobs Act of 2017, see our Client Memorandum cited in *supra* note 3, under "Implications Of The Ninth Circuit Opinion."

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
Ronald E. Creamer, Jr.	+1-212-558-4665	creamerr@sullcrom.com
David P. Hariton	+1-212-558-4248	haritond@sullcrom.com
Jeffrey D. Hochberg	+1-212-558-3266	hochbergj@sullcrom.com
Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
Andrew P. Solomon	+1-212-558-3783	solomona@sullcrom.com
David C. Spitzer	+1-212-558-4376	spitzerd@sullcrom.com
Davis J. Wang	+1-212-558-3113	wangd@sullcrom.com
S. Eric Wang	+1-212-558-3328	wangs@sullcrom.com
Isaac J. Wheeler	+1-212-558-7863	wheeleri@sullcrom.com
Assaf Y. Prussak	+1-212-558-4695	prussaka@sullcrom.com
Eran Levy	+1-212-558-3976	levyel@sullcrom.com
Washington, D.C.		
Donald L. Korb	+1-202-956-7675	korbd@sullcrom.com
London		
Ronald E. Creamer, Jr.	+44-20-7959-8525	creamerr@sullcrom.com
S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com