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Ninth Circuit Reverses Tax Court, Upholds Treasury Regulation on Cost-Sharing Arrangements

Decision has Significant Implication for Judicial Review of Treasury Regulations and for Corporations' Ability to Deduct Costs of Stock Compensation

SUMMARY

On July 24, 2018, in *Altera Corporation* v. *Commissioner*,[1] the U.S. Court of Appeals for the Ninth Circuit, in a two-to-one decision, 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, and therefore cannot deduct, 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 Ninth Circuit's decision is noteworthy in three respects. First, although the Ninth Circuit's analysis confirms that Treasury Regulations are subject to scrutiny for compliance with the "reasoned decision-making" requirements of the Administrative Procedure Act ("APA"),[3] the Ninth Circuit evidenced a deferential attitude toward Treasury's rulemaking process, which, if followed by other courts, would render Treasury Regulations more difficult to challenge as violating the requirements of the APA.

Second, U.S. multinational corporations that, acting in reliance on the Tax Court ruling, did not share stock-based compensation costs with their non-U.S. subsidiaries may face a significant financial impact and must now quantify the effect of the Ninth Circuit majority opinion's decision on them.

Third, it is worth noting that, at the time the Ninth Circuit issued its decision, one of the two judges in the majority, Judge Stephen Reinhardt, had been deceased for over three months. The opinion notes,

however, that Judge Reinhardt "fully participated in this case and formally concurred in the majority opinion prior to his death," but the lack of an actual two-judge majority may call the validity of the opinion into question.[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. 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.[5]

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.[6] In 2002, in response to the ongoing litigation in *Xilinx*, Treasury issued a notice of proposed rulemaking and notice of a public hearing with respect to proposed amendments to the then-existing Treasury Regulations under Section 482. The proposed amendments sought to clarify that stock-based compensation costs must be shared in QCSAs and to provide rules for measuring the costs of stock-based compensation. In response to the proposed amendments, commentators informed Treasury that unrelated parties did not, in fact, share stock-based compensation costs and that unrelated parties would not share such costs. Nonetheless, in 2003, Treasury issued the final Treasury Regulations (the "2003 Treasury Regulations") on this issue,[7] which 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 the final rule (the "SBC rule"). Altera challenged these 2003 Treasury Regulations under the APA.

B. REVIEW OF AGENCY ACTION UNDER THE APA

Under the APA, an administrative agency must give notice of a proposed rule, provide the opportunity for public comment on such proposed rule and "consider and respond to significant comments" received from the public. Further, the agency must describe the basis and purpose for a final rule.[8] Although the APA

empowers courts to review agency action and sets out six separate standards a reviewing court could rely on to set aside an agency rule (including on the grounds that such agency action is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law"),[9] a court's review of agency action under the APA is narrow and limited to ensuring that the agency "engaged in reasoned decision-making."[10] A number of seminal cases inform judicial review of agency decision-making.

In *Motor Vehicles Manufacturers Association of the United States* v. *State Farm Mutual Auto Insurance Co.* ("*State Farm*"), the U.S. Supreme Court provided that to engage in reasoned decision-making, "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[11] Under the standard enunciated by the Supreme Court in *Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.* ("*Chevron*"), if agency decision-making is procedurally valid under the APA, a court reviews the agency's substantive interpretation of a statute pursuant to a two-step analysis. A court must first determine whether "Congress has directly spoken to the precise question in issue." If the statute is silent on the particular question or ambiguous, then a court defers to the agency's interpretation if "it is based on a permissible construction of the statute"[12] and is not "arbitrary or capricious in substance, or manifestly contrary to the statute."[13]

In recent years, a number of taxpayers have challenged IRS actions under general administrative law rules.[14] The Supreme Court has confirmed that the same administrative law principles that govern judicial review of agency action for all other federal agencies apply to the IRS as well.[15]

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 born 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 United States, 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%. In contrast, under then-applicable law, any stock-based compensation costs allocated to the Cayman Islands subsidiary would not result in a valuable deduction because the Cayman Islands did not impose a corporate income tax and, assuming Altera planned to leave the earnings in its foreign subsidiary, any U.S. tax on income would be deferred so long as the income remained offshore. The recently passed tax reform bill, however, requires that retained earnings of a foreign subsidiary on which U.S. tax has been deferred be treated as "repatriated" in the last taxable year of the foreign subsidiary which begins before January 1, 2018. This income will be subject to U.S. tax at rates of 15.5% for earnings held in cash and 8% for all other earnings. As a result,

expenses from periods prior to 2018 allocated to a foreign subsidiary would not be deductible at a 35% rate, but instead would reduce the repatriation tax imposed at a 15.5% or 8% rate, as applicable.

The IRS issued Altera notices of deficiency 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. 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.[16] 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.

NINTH CIRCUIT DECISION

In its briefs before the Ninth Circuit, the government argued that the 2003 Treasury Regulations were procedurally valid, because Treasury complied with APA requirements, including the requirements that an agency sufficiently explain its rationale for adopting a rule and adequately respond to comments. The government further asserted that Treasury is entitled to deference under "*Chevron* deference" as set forth in *Chevron,* because the 2003 Treasury Regulations constituted a reasonable interpretation of Section 482.

The Ninth Circuit subjected Treasury's rulemaking process to the same *State Farm* and *Chevron* analyses as set forth in the Tax Court opinion, but, nonetheless, the Ninth Circuit reversed the opinion (reviewed and agreed to by fourteen Tax Court judges) in a two-to-one decision in which one judge of the two-judge majority, Judge Reinhardt, pre-deceased the opinion's release by several months (although, as provided above, the opinion notes that the late Judge Reinhardt "fully participated in this case and formally concurred in the majority opinion prior to his death").[17] The Ninth Circuit majority opinion determined 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 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.

In rejecting the argument that Treasury did not adequately consider and respond to public comments, the Ninth Circuit majority opinion focused on particular statements made by Treasury in its notice of proposed rulemaking relating to the "commensurate with income standard" set forth in Section 482. In those statements, Treasury said that it intended to coordinate the "commensurate with income standard" with the arm's-length standard that forms the backbone of the Section 482 regulations. The public comments at issue in this case argued that unrelated parties do not share stock-based compensation costs and therefore inclusion of such costs in a QCSA violated the arm's-length standard. The Ninth Circuit majority opinion found that these public comments had no bearing on Treasury's consideration of the relevant factors because of Treasury's reliance on the "commensurate with income standard" as a separate standard from the arm's-length standard. Therefore, Treasury's limited response to these comments was sufficient under the APA.

The dissenting opinion pointed out that Treasury's position in the preamble of the 2003 Treasury Regulations appeared to be that the SBC rule is consistent with the "arm's-length standard" (rather than being an alternative),[18] but the Ninth Circuit majority opinion was satisfied that, "[w]ith [Treasury's] references to legislative history [of the 1986 statutory amendment to Section 482 adding the "commensurate with income standard"], Treasury communicated its understanding that Congress had called upon it to move away from the traditional arm's length standard."[19] The dissent noted that, if Treasury was moving away from the arm's-length standard, "the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it is changing position."[20]

The Ninth Circuit majority opinion also stated that Treasury's litigation position in this case is not inconsistent with statements made in the rulemaking process. Although *Altera* argued that Treasury cannot now take the position that no comparability analysis is required when Treasury did not state that it was empowered to do so under Section 482 during rulemaking, the Ninth Circuit majority opinion found that argument lacked merit and, regardless, Treasury's discussion of the legislative history of the 1986 amendment (adding the "commensurate with income standard" to Section 482) during the rulemaking process was sufficient to support Treasury's current position. Notably, the dissent would, as noted above, require Treasury to have explicitly provided it was moving away from the comparability analysis required under the traditional understanding of the arm's-length standard in order to satisfy the APA's requirements.

The Ninth Circuit majority opinion believed Treasury's position was logical and supported by industry norms, noting that Treasury observed that parties would not ignore such costs if one party incurred the costs and another party had agreed to reimburse the costs. Although the Ninth Circuit majority opinion recognized that the economic costs of employee stock compensation are questionable, because parties would actually account for (and deduct) the costs of employee stock compensation, the Ninth Circuit majority opinion found it is reasonable for Treasury to allocate such costs. Furthermore, the Ninth Circuit majority opinion did not require Treasury to have reviewed actual documentation of parties accounting for costs of employee stock compensation. In contrast, the dissent agreed with the Tax Court that certain policies, such as the sharing of these costs, require an agency to consider empirical data in order to comply with the APA's requirements.

The Ninth Circuit majority opinion also rejected the argument that the SBC rule represents a shift in policy that would require additional justification from Treasury. Rather, the Ninth Circuit majority opinion concluded that there was no policy shift to the extent the arm's-length standard permitted allocation of costs without a comparability analysis, and, even if there was a policy shift, the shift occurred in 1986 when Congress amended Section 482 to include the "commensurate with income standard."

Concluding that Treasury met the administrative requirements in promulgating the SBC rule, the Ninth Circuit majority opinion then concluded that Treasury's interpretation of Section 482 was entitled to deference under *Chevron*'s two-part test 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.

IMPLICATIONS OF THE NINTH CIRCUIT OPINION

The Ninth Circuit majority opinion's decision in *Altera* confirms that stock-based compensation costs must be shared under QCSAs and, significantly, shows a deferential approach to reviewing Treasury interpretations under the APA. Although it appears that the Tax Court reviewed Treasury Regulations under a thorough application of the administrative law principles in the APA and held Treasury to the reasoned decision-making standard enunciated in *State Farm* (an approach that Judge O'Malley would affirm in her dissent), the Ninth Circuit majority opinion decision casts some doubt on the efficacy of continued use of the APA to challenge tax regulations. Specifically, the Ninth Circuit majority opinion provided that a perfunctory response by Treasury to dismiss oppositional comments that Treasury believes are insignificant and would not change a proposed rule is not fatal to compliance with the requirements of the APA. Furthermore, the Ninth Circuit majority opinion would accept oblique statements from Treasury regarding legislative history as sufficient to indicate Treasury's intent with respect to a given rule, whereas both the Tax Court and the dissenting opinion would find that the APA requires more direct statements. Moreover, the Ninth Circuit majority opinion's analysis reveals great

deference to Treasury's interpretation of the Internal Revenue Code under *Chevron*. If extended to other cases, this ruling could provide significant deference to Treasury rulemaking.

The Ninth Circuit majority 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. These companies will face adjustments for open tax years resulting in additional taxes at the then-existing 35% corporate income tax rate. This means that these U.S. multinationals will now face more income taxed at the former 35% U.S. corporate income tax rate, which income would otherwise be subject to the lower rate of the deemed repatriation tax imposed by the tax reform bill passed last December. Pursuant to the deemed repatriation tax, undistributed earnings from offshore affiliates are deemed repatriated to the United States and are subject to tax at rates of 15.5% for earnings held in cash and 8% for all other earnings. Companies will need to consider how to disclose the effect of the Ninth Circuit majority opinion's decision, especially in regard to their anticipated tax benefits and effective tax rates.

Finally, the Ninth Circuit may grant a rare *en banc* review of *Altera* in light of one judge of the two-judge majority pre-deceasing the opinion's release. Also weighing in favor of *en banc* review is the fact that, 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 the Supreme Court for review.

Treasury Regulations continue to be challenged under the APA in other Circuit Courts. Significantly, a recent decision from a federal district court in Texas, *Chamber of Commerce of the United States of America* v. *IRS*,[21] 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 comment. The decision requires that temporary Treasury Regulations comply with the APA's notice and comment process. The government has filed an appeal of that decision to the Fifth Circuit, and further developments in that case should be monitored closely. Additionally, the United States Court of Appeals for the District of Columbia Circuit in a recent decision, *Good Fortune Shipping SA v. Commissioner*,[22] 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.[23] Thus, challenging Treasury regulations on the basis of the APA and *Chevron* deference continues to be an area in flux that requires close monitoring.

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ENDNOTES

[1] 2018 WL 3542989 (9th Cir. 2018).

[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] 5 U.S.C. secs. 551-559, 701-706 (2012).

[4] 2018 WL 3542989, at *1.

[5] 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.").

[6] 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.

[7] 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.

[8] 5 U.S.C. sec. 553 (2012); *Perez* v. *Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1203 (2015).

[9] 5 U.S.C. sec. 706(2)(A).

[10] *Judulang* v. *Holder*, 132 S. Ct. 476, 483 (2011).

[11] 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168 (1962)).

[12] *Id.* at 842-43.

[13] *Mayo Foundation for Medical Educ. & Research* v. *United States*, 562 U.S. 44, 53 (2011) (quoting *Household Credit Servs., Inc.* v. *Pfenning*, 541 U.S. 232, 242 (2004)) (internal quotations omitted).

[14] *See, e.g., Dominion Res., Inc.* v. *United States*, 681 F.3d 1313 (Fed. Cir. 2012) (applying *State Farm* and finding that Treasury failed to provide an adequate explanation for a Treasury Regulation under Section 263A of the Code; consequently, the Treasury Regulation at issue was procedurally invalid).

[15] *See Mayo Foundation for Medical Education and Research* v. *United States*, 562 U.S. 44 (2011).

[16] 145 T.C. 91 (2015).

[17] Judge Stephen Reinhardt died almost four months prior to the opinion's release, although he "fully participated in this case and formally concurred in the majority opinion prior to his death."

[18] The dissent expounded on Treasury's preamble to the 2003 Treasury Regulations: "Throughout the preamble, Treasury repeatedly emphasized that it was applying the arm's length standard. Treasury explained, for example, that '[t]he regulations relating to QCSAs *have as their focus* reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles.'" *Altera*, 2018 WL

ENDNOTES (CONTINUED)

3542989, at *22 (quoting Compensatory Stock Options under Section 482, 68 Fed. Reg. 51, 171, 51, 173 (Aug. 26, 2003)).

[19] *Id.* at 31.

[20] Citing to *FCC* v. *Fox Television Stations, Inc.*, 556 U.S. 502, 514-15 (2009). Under *FCC* v. *Fox Television Stations, Inc.*, an agency cannot "depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." 556 U.S. 502, 515 (2009). In order to change an existing policy and comply with the APA, an agency must show (i) it is aware it is changing the position, (ii) that the new policy comports with the applicable statute, (iii) the agency itself believes the new policy is an improvement, and (iv) there are good reasons for the new policy. *Id.* at 515.

[21] 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.

[22] 2018 WL 3595945 (D.C. Cir. 2018).

[23] *Id.* at *5-7.

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