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Altera Redux – The Ninth Circuit Once Again Holds in Favor of the IRS

Last August, just weeks after handing the IRS a big victory, the Ninth Circuit withdrew its opinion in *Altera v. Commissioner.* Luckily for the IRS, it once again came out on top in the Ninth Circuit's June 7, 2019 opinion. In a 2-to-1 decision, the Ninth Circuit overturned a 2015 unanimous U.S. Tax Court decision regarding the validity of a set of Treasury regulations. It is possible that the Ninth Circuit's 2019 opinion will not be the last word. On July 22, 2019, Altera Corp. petitioned the Ninth Circuit for a rehearing of the case en banc.

A Bit of Background

Altera Corp., a Delaware corporation, and its subsidiary Altera International, a Cayman Islands corporation, entered into a technology R&D cost-sharing agreement under which the related participants agreed to pool their resources to conduct R&D. This agreement was effective from May 23, 1997 through 2007. During the 2004–2007 taxable years, Altera Corp. granted stock options and other stock-based compensation to certain employees who performed R&D activities pursuant to the agreement. The employees' cash compensation was included in the cost pool under the agreement, but their stock-based compensation was not.

The IRS sent Altera notices of deficiency for its 2004–2007 tax years, and allocated income from Altera International to Altera Corp. by increasing Altera International's cost-sharing payments to bring Altera in compliance with the Treasury regulations under Section 482 of the Code. The regulations require parties to a qualified cost-sharing agreement (QCSA) to include stock-based compensation costs in the cost pool, thus sharing such costs, in order to comply with the arm's-length standard.

Altera challenged the validity of the Treasury regulations in the U.S. Tax Court, arguing that the rule is arbitrary and capricious. In its 2015 decision, the Tax Court dealt a blow to Treasury and the IRS when it unanimously held that Treasury Regulations Section 1.482-7(d)(2) was invalid under the Administrative Procedure Act (APA). The Tax Court reasoned that the IRS could not require related parties to share stock compensation costs because the IRS had not considered any unrelated party transactions where the parties shared such costs. The Tax Court also held that Treasury's rulemaking process was fundamentally flawed because it rested on speculation rather than on hard data and expert opinions and because Treasury failed to respond to significant public comments.

The Tax Court decision was appealed to the U.S. Court of Appeals for the Ninth Circuit. Two of the three judges on the original Ninth Circuit panel were more sympathetic to the government's position, and in the court's July 2018 opinion, reversed the Tax Court decision. The court held that the regulations were a permissible interpretation of Section 482. In addition, the court held that Treasury's rulemaking did not violate the APA, finding that the regulations were a reasonable interpretation of the statute and finding no serious issues with the government's conduct during the rulemaking process. Unfortunately for the IRS, in August 2018 the Ninth Circuit decided to withdraw its opinion because of the death of the concurring judge several months before the decision was issued.

The Ninth Circuit Has Spoken… Again

The deceased judge on the original panel was replaced by a new judge, and on October 18, 2016, the case was reargued in front of the reconstituted panel. On June 7, 2019, the Ninth Circuit issued a new opinion, which is largely the same as the withdrawn 2018 opinion. Again, two of the three judges on the Ninth Circuit panel held to reverse the Tax Court decision.

Several significant questions were addressed in the Ninth Circuit's 2019 opinion.

What is the meaning of "commensurate with income"?

The central issue of the case is whether the government can allocate a cost between related parties that unrelated parties dealing at arm's length would not agree to share. Altera argued that the arm's-length standard requires a comparability analysis, while the IRS argued that it is consistent with the arm's-length standard to apply an internal method of allocation that distributes costs between the parties proportionate to their costs and income. The IRS has a history of saying that the "commensurate with income" standard is consistent with the arm's-length standard, but here both the court and the IRS took the position that in circumstances such as this, the commensurate with income standard allows the IRS to escape from the requirement to follow comparables. On appeal, the IRS argued that it is wrong to presume that evidence of behavior between unrelated parties in similar circumstances is the only way to meet the arm's-length standard. The IRS relied on the 1986 addition of the "commensurate with income" language to Section 482 in support of its proposition that the arm's-length standard does not require evidence of unrelated party conduct in all instances. The court found that this added language made it reasonable for Treasury to conclude that a comparable transaction analysis is not necessary in the absence of actual comparable transactions. The court held that a flexible approach can be taken with the arm's-length standard, stating: "the arm's length standard has historically been understood as more fluid than Altera suggests."

However, in the dissent, Judge O'Malley argues that Treasury's only justification for avoiding the comparability analysis was its insistence that the legislative history allows it to disregard comparable transactions that it deems imperfect, which is entirely inconsistent with the plain text of the statute and thus impermissible under *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc*. Similarly, in its recent petition, Altera argues that the government's assertion that the commensurate with income language in Section 482 allows the IRS to make its own internal judgment about what would be an arm's-length result never appeared in the rulemaking record and was "made up for litigation."

What is the meaning of "transfer or license of intangible property" in the second sentence of Section 482?

In order to apply the "commensurate with income" language in the second sentence of Section 482 and take a more flexible approach to the arm's-length standard, the IRS had to first convince the court that a QCSA constituted a transfer of intangibles. The IRS argued, and the court was evidently persuaded, that the transfer of future distribution rights over IP is the primary incentive for entering into a QCSA, so therefore the second sentence of Section 482 applies to the case at hand.

This clearly seemed like a stretch to Judge O'Malley. In her dissent, Judge O'Malley disagreed with the majority that the term "transfer" should be read so broadly that it encompasses the allocation of rights to distribute intangibles to be created in the future. Judge O'Malley stated: "No rights are transferred when parties enter into an agreement to *develop* intangibles; this is because the rights to later-developed intangible property would spring *ab initio* to the parties who shared the development costs without any need to transfer the property."

How is this case reconciled with Xilinx*?*

In its 2010 decision in *Xilinx Inc. v. Commissioner*, the Ninth Circuit addressed whether stock-based compensation costs must be included in the costs shared under a cost-sharing agreement during years before the issuance of the 2003 regulations, which require that stock-based compensation costs be included in the costs shared under a cost-sharing agreement. Persuaded by evidence that arm's-length parties do not share stock-based compensation costs, the Ninth Circuit held that a cost-sharing agreement did not have to include stock-based compensation costs under the pre-2003 regulations.

Altera unsuccessfully argued that the Ninth Circuit's decision in *Xilinx* should control the outcome here. The court stated: "Although the *Xilinx* panel could have reached a holding that would foreclose the Commissioner's current position, it did not." The court distinguished *Xilinx* from the case at hand because *Xilinx* did not involve the question of statutory interpretation, the commissioner's authority, or the regulation at issue in *Altera*. Judge O'Malley, however, saw no reason to distinguish *Xilinx*. In its petition for rehearing, Altera argues that the Ninth Circuit should grant rehearing en banc to reconcile its divergent decisions in *Xilinx* and the 2019 *Altera* opinion.

What does this case say about the promulgation of regulations under the APA and State Farm*?*

Altera argued that although Treasury solicited public comments on the proposed regulations, it did not adequately respond to those comments, rendering the regulations arbitrary and capricious under the standards established by *Motor Vehicle Manufacturers Association of the U.S. v. State Farm*. (As a constitutional law refresher: *State Farm* is used to evaluate whether a rule is procedurally defective as a result of flaws in the agency's decision-making process.) However, the court concluded that Treasury complied with the procedural requirements of the APA, and therefore the regulation survives *State Farm* scrutiny. The court found that Treasury satisfied the three-step rulemaking procedure for notice and comment rulemaking, which requires that the agency: (1) publish notice of the proposed rule in the *Federal Register*; (2) provided that notice is required, give interested persons an opportunity to participate in the rulemaking through the submission of written comments; and (3) consider and respond to significant comments received. The Tax Court held that Treasury failed to satisfy the third step, since it believed that Treasury ignored significant comments. However, the Ninth Circuit opinion disagreed with the Tax Court's finding. The court stated that it could not fault Treasury for refusing to respond to comments that proved irrelevant to its decision-making process. The court believed the comments were just expressing disagreement with Treasury's interpretation of the law, since the commentators attacked the regulation as inconsistent with the arm's-length standard. Although the court admits that Treasury's rulemaking process may not have been perfect here, the opinion states: "we may not set aside agency action simply because the rulemaking process could have been improved."

Judge O'Malley, however, did not consider the comments received by Treasury during the rulemaking process to be irrelevant. She came to the same conclusion as the Tax Court that Treasury failed to consider comparable transactions submitted by commentators demonstrating that unrelated companies would never share the cost of stock-based compensation. Judge O'Malley also found that Treasury's notice of proposed rulemaking "ran afoul" of the APA's safeguards, which ensure that those regulated do not have to guess at the regulator's reasoning and afford regulated parties a meaningful opportunity to respond to that reasoning. In its petition for rehearing, Altera now argues that "the panel's decision turns 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 never was subject to public scrutiny."

What does this case say about the Chevron *standard of review?*

The Ninth Circuit held that the Treasury regulations are entitled to deference under *Chevron*. (As a constitutional law refresher: under *Chevron*, when Congress has not directly addressed the issue under consideration, the court must uphold the regulation unless it is arbitrary and capricious in substance or manifestly contrary to the statute.) The court first determined that Section 482 does not speak directly to whether the IRS may require parties to a QCSA to share employee stock compensation costs to receive the tax benefits associated with entering into a QCSA. The court then considered whether Treasury's interpretation of Section 482's allocation of employee stock-option costs is permissible. After reviewing relevant legislative history, the court found that Congress's objective in amending Section 482 was to ensure that income follows economic activity and to grant Treasury the authority to develop methodology that did not rely on analysis of problematic comparable transactions. The court held that Treasury reasonably understood Section 482 as an authorization to require internal allocation methods in the QCSA context, provided that the costs and income follow the economic activity.

Altera argued that Congress did not intend for the amendment adding the second sentence to Section 482 to alter the arm's-length standard, citing the canon of statutory construction that provides that amendments by implication are not favored. The court disagreed, stating: "It is illogical to argue that amending a singular statute does not alter its meaning." The court said that Altera's reading would limit the "commensurate with income" clause to narrow circumstances, essentially rendering it meaningless.

What Will Happen Next?

Many taxpayers and practitioners will be watching closely for developments now that Altera has filed a petition for rehearing. As evidenced by the large number of amicus briefs filed in the *Altera* appeal, the question of whether related parties must share stock-based compensation costs is exceptionally important.

For more information, please contact Henry Birnkrant at 202.239.3319, Ryan Kelly at 202.239.3306, or Stefanie Kavanagh at 202.239.3914

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

International Tax Group

John F. Baron
Chair
704.444.1434
john.baron@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Seth M. Buchwald
404.881.7836
seth.buchwald@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Sam K. Kaywood, Jr.
404.881.7481
sam.kaywood@alston.com

Ryan J. Kelly
202.239.3306
ryan.kelly@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

Edward Tanenbaum
212.210.9425
edward.tanenbaum@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: Chase Tower ▪ 2200 Ross Avenue ▪ Suite 2300 ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ▪ Suite 600 ▪ Raleigh, North Carolina, USA, 27601-3034 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333