



IRS files notice of appeal in *Altera* case

Global Transfer Pricing Alert 2016-005

The Internal Revenue Service on February 19 filed a notice of appeal in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015), to the Ninth Circuit Court of Appeals (Docket Nos. 006253-12 and 009963-12). The Ninth Circuit will decide whether a regulation that mandates that stock-based compensation (SBC) costs related to the intangible development activity of a qualified cost sharing arrangement (QCSA) must be included in the joint cost pool of the QCSA (the “all costs rule”) is consistent with the arm’s length standard as enunciated under section 482. This is the second time the Ninth Circuit will consider this issue, and the first time the issue will be considered since the regulations were amended in 2003 to specifically include SBC costs in the all costs rule. The Ninth Circuit invalidated a prior version of the all costs rule that did not specifically mention SBC costs in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff’d*, 598 F.3d 1191 (9th Cir. 2010).

Factual Background

The taxpayer-petitioner in this case, Altera Corporation, develops, manufactures, and sells programmable logic devices (PLDs) and related hardware, software, and predefined design building blocks for use in programming the PLDs. On May 23, 1997, Altera U.S., the parent corporation incorporated in Delaware, and Altera International, a subsidiary of Altera U.S. incorporated in the Cayman Islands, entered into a technology license agreement and a technology research and development (R&D) cost sharing agreement that met the requirements of a QCSA under the 2003 cost sharing regulations.

During Altera’s 2004-07 tax years, Altera U.S. granted stock options and other SBC costs to some of its employees, including employees who performed R&D activities subject to the QCSA. Those employees’ cash compensation was included in the cost pool under the QCSA, but the SBC costs were not. The IRS sent Altera notices of deficiency for those tax years, making allocations of \$15,463,565 in 2004, \$23,015,453 in 2005, \$17,365,388 in 2006, and \$15,463,565 in 2007, all pursuant to the all costs rule requiring that such SBC be included in the joint cost pool for the QCSA.

Tax Court Decision

Altera challenged the adjustments, and contested the validity of all costs rule. Altera argued that, in adopting this rule, the IRS had violated the Administrative Procedure Act (APA). The Tax Court agreed with Altera in a 15-0 decision on July 27, 2015, and concluded that the regulation was invalid because the IRS and Treasury had failed to satisfy the requirements of the APA. Specifically, when the IRS and Treasury issued the final rule, the files they maintained did not contain any expert opinions, empirical data, published or unpublished articles, papers, surveys, or reports supporting a determination that the amounts attributable to SBC costs must be included in the cost pool of the QCSA to achieve an arm’s length result consistent with section 482 and the other regulations adopted under the statute. Additionally, when the IRS and Treasury issued the final rule, they were not aware of any written contracts between unrelated parties, whether in a cost sharing arrangement or not, that required one party to pay or reimburse the other for amounts attributable to SBC costs. Moreover, the Tax Court found that the IRS had not sufficiently rebutted taxpayer’s

assertions that inclusion of such costs was not consistent with the arm's length standard adopted in the section 482 regulations.

Procedural Posture on Appeal

The IRS is now appealing the unanimous U.S. Tax Court opinion described above. The Tax Court decision caused taxpayers engaged in cost sharing arrangements to reevaluate whether to continue including SBC costs as part of the total costs included not only for purposes of Treas. Reg. §1.482-7, but also Treas. Reg. §1.482-9. Such an evaluation requires analysis of the facts surrounding the cost sharing arrangement on a case-by-case basis.

On appeal, the Ninth Circuit will consider all the legal arguments and it will not be bound by any of the Tax Court's legal determinations in the case.

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