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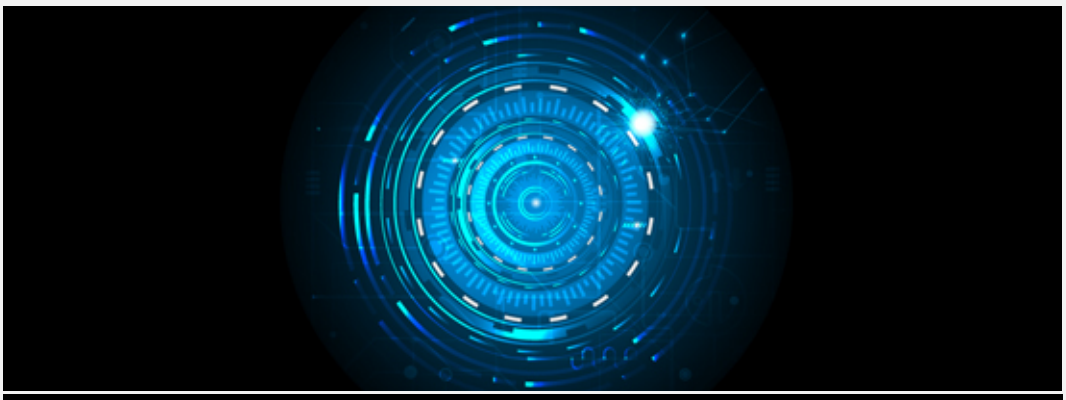

Ninth Circuit Court of Appeals reverses Tax Court in *Altera*

Global Transfer Pricing Alert 2019-018

The United States Ninth Circuit Federal Court of Appeals on June 7 reversed the Tax Court decision in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015).[1] At issue was the validity of 26 C.F.R. §1.482-7A(d)(2),[2] which 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). A three-judge panel ruled 2-1 that the all costs rule is consistent with section 482 and therefore that such costs must be included in the cost pool.

This is the second case in which the Ninth Circuit has considered this issue, and the first case in which the issue has been 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.

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

[1] This is the second opinion issued by the Ninth Circuit regarding Altera Corporation. The initial opinion was withdrawn because one of the judges on the original three-judge panel died before the initial opinion was issued. That judge was then replaced by another judge from the Ninth Circuit drawn by lot.

[2] The regulations at issue were originally designated as Treas. Reg. §1.482-7 but were then redesignated as Treas. Reg. §1.482-7A by TD 9441. To minimize confusion, the citations in this alert are to the current version of the regulation unless otherwise specified.

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 $24,549,315 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 costs be included in the joint cost pool for the QCSA.

Tax Court Decision

Altera challenged the adjustments and contested the validity of the 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 the taxpayer's assertions that inclusion of such costs was not consistent with the arm's length standard adopted in the section 482 regulations.

Ninth Circuit Majority Opinion

The IRS appealed the unanimous US Tax Court opinion described above. On appeal, the Ninth Circuit considered all legal arguments and was not bound by any of the Tax Court's legal determinations in the case. The panel of three judges reversed the Tax Court, with one judge dissenting.

In its majority opinion, the Ninth Circuit held that the all costs rule complied with the APA and was therefore entitled to deference.

The majority opinion stated that:

- The legislative history of section 482 supported the Treasury Department's decision to apply the commensurate with income (CWI) principle as the basis for promulgating the all costs rule. In addition, given such legislative history, it was reasonable for

Treasury to decide that uncontrolled cost sharing arrangements do not provide helpful guidance regarding allocations of employee stock compensation between controlled parties.

- The second sentence of section 482 (for CWI) applies to QCSAs, and thus could be used as the basis for the SBC rule, because cost sharing transactions in QCSAs involve a transfer of rights to intangible property that has not yet come into existence.
- The Treasury Department provided adequate notice of its intent to promulgate the all costs rule by citing to the legislative history pertaining to the promulgation of the CWI principle in the notice for the 2003 SBC rule, and again in the preamble for the 2003 SBC regulation.
- The Treasury Department adequately considered the objections raised by commentators, including the objections that unrelated parties would not share SBC costs. Such comments, the majority held, were irrelevant, because Treasury had provided adequate notice that it was moving away from an analysis of comparable transactions as the exclusive means of achieving an arm's length result.
- Treasury's conclusion that stock-based compensation should be treated as a cost was adequately supported by "tax and other accounting principles."
- The decision in a prior similar case was not controlling, because it did not speak directly to this issue but instead dealt with a conflict between two rules under the section 482 regulations.

Dissenting opinion lays groundwork for appeal?

Judge Kathleen M. O'Malley filed a dissent against the majority opinion. The dissent maintained that Treasury did not satisfy the reasoned decision-making standard and that the all costs rule was invalid as arbitrary and capricious.

In particular, the dissent argued that, until the promulgation of the regulation in question, the Treasury Department consistently asserted that the only way to determine the arm's length standard was to conduct a comparability analysis. The dissent continued by saying that "[in this regulation] Treasury stated for the first time and with no explanation, that it may, *instead*, employ the 'commensurate with income standard' to reach the required arm's length result." (Emphasis in original). The dissent argued that this kind of switching of position by a federal agency is precisely the kind of activity that the APA, and the case law interpreting it, has indicated is unacceptable. Additionally, the dissent argued that taxpayers were not on notice of the change in position based on "cryptic" citations to legislative history because the APA, and the case law interpreting it, has indicated that the federal agencies must explain their changes in position, and the "cryptic" references to CWI legislative history were not sufficient to do so.

The dissent further argued that QCSAs are not subject to the second sentence of section 482 (for CWI) because it does not make sense to say that something that has not yet come

into existence (and may never come into existence) can be transferred. In addition, the dissent maintained that the Treasury Department did not adequately consider the objections raised by commentators, particularly the objections that there was no evidence showing unrelated parties would share SBC costs. Finally, the dissent would have held that a prior similar case did control and that this would therefore require the Tax Court's decision to be affirmed.

What comes next?

In a civil case involving a United States agency like the IRS, such as this case, the parties may file a motion for rehearing *en banc* within 45 days after entry of judgment.[3]

Alternatively, the parties can bypass the *en banc* panel and seek relief at the United States Supreme Court (they can also seek Supreme Court relief if they are turned down for an *en banc* hearing or lose at the *en banc* panel). In that case, the parties have 90 days to file a request to the clerk of the Supreme Court after the entry of the judgment.[4]

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[3] FRAP 40(a)(1).
[4] US Supreme Court Rule 13.

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