Deloitte.

Global Transfer Pricing

Contacts:

Joseph Tobin
jtobin@deloitte.com

Kerwin Chung
kechung@deloitte.com

Alan Shapiro
ashapiro@deloitte.com

Ron Saake
rsaake@deloitte.com

U.S. Tax Court's *Altera* Decision Raises Broader Questions

TP ALERT 2015-012
August 19, 2015

By Joseph Tobin (Washington DC)

The U.S. Tax Court on July 27 held, in a unanimous 15-0 decision in *Altera Corp. v. Commissioner*, that a rule promulgated under the 1995 cost sharing regulations requiring participants in a qualified cost sharing arrangement (QCSA) to share stock-based compensation (SBC) costs related to the intangible development area (IDA) of the QCSA (i.e., Treas. Reg. § 1.482-7(d)(2)(2003), the "all costs rule") did not satisfy the reasoned decision-making standard, and is thus invalid, under the standards enunciated in *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983) and *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). In so holding, the *Altera* court found that, in promulgating the all costs rule, the Treasury and the IRS had failed to explain how it was consistent with the fundamental principle underlying the regulations promulgated under section 482 of the Internal Revenue Code (IRC), i.e., the arm's length standard (Treas. Reg. §1.482-1(b)(1)), given that all evidence proffered indicated that it was not. This decision raises serious issues about whether taxpayers should continue to include 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. Taxpayers should consult with their local Deloitte Transfer Pricing and International Tax contacts to discuss the consequences of this decision on their QCSA and other transfer pricing policies.

Factual and Procedural 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 (TLA) and a technology research and development (R&D) cost-sharing agreement (CSA). Under the TLA, Altera U.S. licensed to Altera International the right to use and exploit, everywhere except the United States and Canada, all of Altera U.S.'s intangible property relating to PLDs and programming tools that existed before the CSA. Under the CSA, Altera U.S. and Altera International agreed to pool their respective resources to conduct research and development using the pre-cost-sharing intangible property relating to PLDs. Altera U.S. and Altera International also agreed under the CSA to share the costs and risks of R&D activities they performed on or after May 23, 1997, relating to PLDs.

During Altera's tax years 2004 through 2007, Altera U.S. granted stock options and other SBC to some of its employees, including employees who performed R&D activities subject to the CSA. These employees' cash compensation was included in the cost pool under the CSA, but the SBC was not included. 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 SBC related to the IDA of the QCSA to be shared by the participants in the QCSA.

Legal Background

In *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), the Ninth Circuit Court of Appeals upheld the Tax Court's decision that a previous version of the all costs rule (which did not specifically state that SBC must be included) was inconsistent with the arm's length standard (Treas. Reg. 1.482-1(b)(1)) and thus invalid. In *Xilinx*, both the Tax Court and the Ninth Circuit held that the arm's length standard must be followed in all IRC section 482 adjustments, and that the arm's length standard requires an analysis of the *actual behavior of unrelated parties* when they enter into transactions with one another (the "behavioralist" interpretation of the arm's length standard). In doing so, the Tax Court and the Ninth Circuit rejected the IRS's and Treasury's interpretation of the arm's length standard, which allows for the possibility of a "thought experiment" to determine arm's length pricing, rather than focusing solely on the behavior of unrelated parties. The IRS maintains, under the "thought experiment" interpretation of the arm's length standard, that the correct price can be deduced simply by thinking about economic principles and then applying those principles to the facts of the taxpayer's transaction and thereby deriving the correct price in accordance with those principles. Under the behavioralist interpretation of the arm's length standard, though, the Tax Court and Ninth Circuit found that the failure of the IRS to provide any empirical evidence that unrelated parties actually shared SBC costs in similar types of arrangements indicated that requiring taxpayers in QCSAs to do so was inconsistent with the arm's length standard.

2003 Regulations

In July 2002, Treasury issued a notice of proposed rulemaking with respect to proposed amendments to the 1995 cost sharing regulations pertaining to the inclusion of IDA-related SBC in the joint cost pool of QCSAs. Many commentators submitted comments to Treasury indicating that they were not aware of any agreements between uncontrolled parties in which the parties shared SBC costs in a joint venture type of an arrangement like a QCSA. Other submissions to the Treasury indicated that they had surveyed many taxpayers and conducted searches in databases containing relevant contracts and that they had not been able to find any agreements between uncontrolled parties in which the parties shared SBC costs in a joint venture type of an arrangement like a QCSA. Other commentators identified agreements similar to QCSAs in which SBC costs were not shared between the parties. Others submitted economic reports explaining that, from a theoretical perspective, unrelated parties would not agree to share SBC costs because the value of SBC is speculative, potentially large, and completely outside the control of the parties.

Despite all these comments, Treasury issued the final all costs rule in August 2003, explicitly requiring parties to QCSAs to share IDA-related SBC costs. The final rule also added Treas. Reg. 1.482-1(b)(2)(i), indicating that a QCSA produces an arm's length result only if the parties' costs are determined in accordance with the all costs rule. When it issued the final rule, the files maintained by Treasury relating to the final rule did not contain any expert opinions, empirical data, published or unpublished articles, papers, surveys, or reports supporting a determination that the amounts attributable to stock-based compensation must be included in the cost pool of QCSAs to achieve an arm's length result. Additionally, when Treasury issued the final all costs rule, it was unaware 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 party for amounts attributable to stock-based compensation.

Tax Court's Decision

Administrative Law Issue Number 1: Was the All Costs Rule a Legislative or Interpretive Regulation?

Under section 553 of the Administrative Procedure Act (APA), in promulgating regulations through informal rulemaking, an agency must publish a notice of

proposed rulemaking; provide interested persons an opportunity to participate in the rule making; and after consideration of the relevant matter presented, incorporate in the rules adopted a concise general statement of their basis and purpose. These requirements apply only to "legislative rules," not "interpretive rules." Interpretive rules merely explain preexisting substantive law, whereas substantive rules "create rights, impose obligations, or effect a change in existing law." In other words, a legislative rule has the "force of law," whereas an interpretive rule does not. The Ninth Circuit Court of Appeals (which would hear an appeal of this case) has held that a rule has the force of law (and is thus a legislative rule subject to the APA notice and comment requirements) when: (1) in the absence of the rule, there would not be an adequate legislative basis for enforcement action; (2) when the agency has explicitly invoked its general legislative authority; or (3) when the rule amends a prior legislative rule. *Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003).

Altera maintained that the all costs rule was a legislative rule subject to the APA notice and comment requirements. The IRS asserted that it was not a legislative rule, but declined to argue the issue on brief or in oral argument because it maintained that it had met the APA notice and comment requirements. The Tax Court found that it needed to determine the issue to determine whether the APA notice and comment requirements applied to the rule. The Tax Court found that the all costs rule was a legislative rule under the Ninth Circuit's *Hemp* criteria because: (1) Congress delegated legislative power to Treasury under IRC section 7805(b); (2) Treasury intended for the final rule to have the force of law because the parties stipulated that the adjustments to taxpayer's income can be sustained only on the basis of the all costs rule; and (3) Treasury also intended for the final rule to have the force of law because Treasury invoked its general legislative rulemaking authority under section 7805(a) in promulgating the all costs rule. Accordingly, the Tax Court found that the Treasury needed to comply with the APA section 553 requirements in promulgating the all costs rule.

Administrative Law Issue Number 2: What is the Correct Standard of Review for the All Costs Rule?

Altera argued that, under section 706(2)(A) of the APA, a court must "hold unlawful and set aside agency action, findings and conclusions" that the court finds to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." Altera further maintained that a court reviewing an agency rule must ensure that the agency "engaged in reasoned decision making" *Judulang v. Holder*, 132 S. Ct. 476, 483 (2011), and 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'" under *State Farm* (463 U.S. at 43).

The IRS rejected this argument, maintaining that the court should review the validity of the all costs rule under the *Chevron* standard rather than the *State Farm* standard. The IRS maintained that *State Farm* review was not appropriate for the all costs rule because it believed that the interpretation and implementation of section 482 does not require empirical analysis of the behavior of unrelated entities. The Tax Court rejected this argument, citing a prior decision that "determination under section 482 is essentially and intensely factual." *Procacci v. Commissioner*, 94 T.C. 397, 412 (1990). The Tax Court also rejected this argument by indicating that under *Xilinx*, the "arm's length standard always requires an analysis of what unrelated entities do under comparable circumstances." Thus, the Tax Court once again rejected the IRS's thought experiment interpretation of the arm's length standard in favor of the behavioralist interpretation of the arm's length standard that was adopted by the Tax Court and the Ninth Circuit in the *Xilinx* decisions, indicating that the Treasury "necessarily decided an empirical question when it concluded that [the all costs rule] was consistent with the arm's length standard." Accordingly, the Tax Court found that it was appropriate to use the *State Farm* "reasoned decision making" standard of review.

The Tax Court noted that, even if it had used the *Chevron* standard of review instead of the *State Farm* standard of review, the "analysis would be the same" because under step two of the *Chevron* test, it is necessary to determine whether an agency interpretation is "arbitrary or capricious in substance" *Judulang*, 132 S. Ct. at 483, which is the same kind of analysis that is done under the *State Farm*

inquiry. Thus, the Tax Court determined that regardless of whether the correct standard was *Chevron* or *State Farm*, the Treasury process leading to promulgation of the all costs rule needed to satisfy the “reasoned decision making” standard in *State Farm*.

Application of the “Reasoned-Decision-Making” Standard to the All Costs Rule

Applying the “reasoned decision making” standard, the Tax Court agreed with Altera that the all costs rule is invalid because: (1) it lacks a basis in fact; (2) Treasury failed to rationally connect the choice it made with the facts it found; (3) Treasury failed to respond to significant comments; and (4) the all costs rule was contrary to all of the evidence before the Treasury. In making this finding, the Tax Court noted that Treasury ignored a significant amount of empirical evidence submitted by commentators indicating that unrelated parties do not share SBC costs in similar types of arrangements (and was not able to provide any agreements between unrelated parties showing that they had shared SBC costs). The Tax Court also noted that the Treasury ignored (or seemed to concede) several economic analyses submitted by commentators providing theoretical explanations for the lack of empirical evidence. The Tax Court noted several times in its decision that Treasury did not attempt to search for or locate agreements to support its positon. Instead, Treasury relied on the assumption that it had the power to simply define what should be considered arm’s length. Accordingly, the Tax Court found that Treasury’s “ipse dixit conclusion” (that is, Treasury’s conclusion that the all costs rule must be correct “because I say so”), “coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decision making.”

Tax Court Rejects IRS’s “Harmless Error” Arguments

Treasury argued that, pursuant to the harmless error rule of APA section 706, any deficiencies in its reasoning in promulgating the all costs rule should not lead to invalidation of the rule because: (1) the Treasury had sufficient alternative reasons for adopting the rule; and (2) the rule reflects good policy because the Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB) and the Organization for Economic Cooperation and Development (OECD) have adopted policy positions that concur with the rule.

Treasury argued that the commensurate with income (CWI) principle (the second sentence of IRC section 482, indicating that transfers of intangibles must be commensurate with the income attributable to such intangibles) provided a second independent basis for the all costs rule, regardless of whether the all costs rule was consistent with the arm’s length standard. However, the Tax Court stated that the preamble to the 2003 cost sharing regulations never indicated that the Treasury was prepared to rely solely on the CWI principle, and, moreover, the Treasury has always maintained in its treaties and other public statements that its interpretation and application of the CWI principle is consistent with the arm’s length standard. Thus, the Tax Court concluded that if the CWI principle is consistent with the arm’s length standard, then it would be unreasonable for the IRS to conclude that the all costs rule could be consistent with the CWI principle given that it is inconsistent with the arm’s length standard.

The Tax Court also rejected the Treasury’s argument that it should take into account the fact that the rule represented good policy in that it was consistent with FASB, IASB, and OECD rules on treating SBC as a cost. The Tax Court maintained that it did not have to consider whether the all costs rule was good policy, but merely had to decide whether the rule was the result of a reasoned decision making process.

Analysis

The Tax Court’s unanimous 15-0 decision that the all costs rule is invalid may be a strong signal that the IRS may face an uphill battle to overturn the decision if it ultimately decides to appeal to the Ninth Circuit, especially given that the IRS lost on a nearly identical issue in the Ninth Circuit in *Xilinx*.

Whatever the IRS decides to do, this decision may have far-reaching consequences if it is upheld on appeal (or acquiesced to by the IRS), because it

could affect other provisions in the cost sharing regulations that may not have sufficient empirical support, and possibly even provisions in other areas of the tax regulations where empirical support has not been provided.

The decision could also affect the ongoing discussions at the OECD about the base erosion and profit shifting (BEPS) program, because some of the rules proposed as part of the BEPS project have been criticized by multinational enterprises as lacking any empirical support (similar to the taxpayer's successful argument in *Altera*). Thus, the OECD BEPS proposals may come under additional scrutiny and pressure to the extent they lack any empirical grounding.

This decision raises questions with respect to the inclusion of SBC costs as part of the total costs not only for purposes of Treas. Reg. § 1.482-7, but also Treas. Reg. § 1.482-9. The decision also raises a significant number of international tax and tax accounting issues related to how taxpayers should take this decision into account for tax return and financial statement reporting purposes. Taxpayers should consult with their local Deloitte Transfer Pricing and International Tax contacts to discuss the potential consequences of this decision on their QCSA and other transfer pricing policies.

Back to top

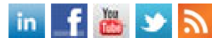
Deloitte.com | **Security** | **Legal** | **Privacy**

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 200,000 professionals, all committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2015. For information, contact Deloitte Touche Tohmatsu Limited.



To unsubscribe, reply to this message and add "Unsubscribe" in the subject line.