Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Altera Reversal Is A Transfer Pricing And APA Win For IRS

By **David Fischer, David Blair, Charles Hwang and Madeline Obler**
(July 30, 2018, 3:41 PM EDT)


David Fischer


David Blair


Charles Hwang


Madeline Obler

In last week's Altera Corp. & Subsidiaries v. Commissioner of Internal Revenue[1] decision, the U.S. Court of Appeals for the Ninth Circuit reversed the U.S. Tax Court and found that a regulation requiring cost sharing of stock-based compensation was valid under the Administrative Procedure Act. The 2015 decision in Altera Corp. v. Commissioner of Internal Revenue[2] was one of the most significant Tax Court cases in recent years both for its transfer pricing holding and, perhaps more importantly, because it provided a landmark application of the APA to tax regulations. The reversal has important implications for cost sharing, specifically, for the use of the APA, and for transfer pricing more generally.

First, Altera holds that under the applicable, now-valid regulations, stock-based compensation must be shared in qualified cost-sharing arrangements, which are common, particularly in high-technology companies. Under such arrangements, U.S. and international affiliates divide revenues, typically based on geography — U.S. and non-U.S. — and are required to share the costs of research and development activities related to those revenues in accordance with projected revenues. The question in Altera was whether stock-based compensation, which is noncash, needed to be included in the costs shared — that is, were the foreign affiliates of Altera U.S. required to pay to Altera U.S. their share of stock-based compensation costs? The Ninth Circuit, overturning the Tax Court, said yes.

Altera marks a significant win for the Internal Revenue Service on this important transfer pricing issue. In recent years, transfer pricing issues have been a major IRS priority. However, the IRS has made headlines by bringing a number of big-dollar cases against multinational companies and subsequently losing many of them. Altera was a test case. Since the IRS began litigating this issue, many cost-sharing arrangements were drafted with contingent provisions specifying whether to include or not include stock-based compensation in the costs to be shared, depending upon the results in Altera. Similarly, many claims for refund are pending with the IRS on this issue. In January 2018, the IRS instructed transfer pricing examiners not to start new examinations of stock-based

compensation in cost-sharing arrangements pending the decision in Altera.[3] Depending on whether the U.S. Supreme Court grants certiorari, the reversal of the Tax Court's holding in Altera will impact these cost-sharing arrangements, refund claims and IRS audits.

Second, the Ninth Circuit opinion affirms that the APA applies to tax cases. The case law under the APA requires an agency issuing regulations through notice and comment procedures to engage in "reasoned decision-making" to avoid running afoul of the arbitrary and capricious standard that applies to agency action in this context. See, for example, Motor Vehicle Manuf. Ass'n of the United States v. State Farm Mutual Auto Ins. Co.[4] However, in applying State Farm, the Ninth Circuit granted more deference to the agency than the Tax Court did — finding that the agency must explain its reasoning, but as long as it does, the courts should grant significant deference to the agency's decision. In Altera, the Ninth Circuit reasoned that U.S. Department of Treasury acknowledged and sufficiently addressed comments to the effect that unrelated parties do not share stock-based compensation costs. The Ninth Circuit found that the adoption of the regulation satisfied the APA and that the regulation should be upheld. In doing so, the Ninth Circuit applied a high degree of deference, referred to as Chevron deference.[5]

The APA portion of Altera raises the issue whether Chevron deference should be reconsidered. This issue is currently under intense discussion outside of the tax area and is ripe for U.S. Supreme Court consideration. The taxpayer in Altera may apply for certiorari to the Supreme Court and Altera may be the case where the Supreme Court once again takes up this issue.

Third, and perhaps most importantly in the long run, the Ninth Circuit ruled that the IRS is not required to use comparable transactions or transfer pricing methods relying on arm's-length comparisons when allocating income under Internal Revenue Code Section 482. Instead, the court held, the IRS is empowered to allocate income in a manner that assures income follows economic activity. The court reasoned that the addition of the "commensurate with income" sentence to Code Section 482 in 1986 permits the IRS to reach arm's-length results without reference to comparable arm's-length transactions. Moreover, it approved Treasury's decision to ignore evidence from commentators on arm's-length cost-sharing arrangements when issuing the regulations.

Altera is the second significant cost-sharing case from the Ninth Circuit, following the 2005 decision, Xilinx Inc. v. Commissioner, which held that sharing of stock-based compensation was not required under previous regulations. Xilinx was also originally reversed in the Ninth Circuit, but the Ninth Circuit subsequently withdrew the reversal and affirmed the Tax Court. Many commentators attribute that change of heart to the uproar caused by the original Ninth Circuit Xilinx opinion, which was seen as contrary to U.S. treaty obligations to apply the arm's-length standard. In Altera, the Ninth Circuit asserts that the arm's-length standard can be applied without following the usual arm's-length methods where comparable transactions do not exist. Whether this is ultimately found to deviate from the arm's-length standard undoubtedly will be the subject of many more opinions and much discussion.

Like the Tax Court opinion, the Ninth Circuit decision in Altera has many significant and interesting implications. Suffice it to say that, even if Altera stands as to the cost-sharing result, it is unlikely it will be sufficient to resolve the APA and transfer pricing issues it raises.

David J. Fischer, David B. Blair and Charles Hwang are partners at Crowell & Moring LLP.

Madeline Obler is an associate at Crowell & Moring LLP.

[1] Altera Corp. & Subsidiaries v. Commissioner (July 24, 2018)

[2] Altera Corp. v. Comm'r, 145 T.C. No. 3 (July 27, 2015)

[3] LB&I-04-0118-005

[4] See Motor Vehicle Manuf. Ass'n of the United States v. State Farm Mutual Auto Ins. Co., 463 U.S. 837 (1983).

[5] See Chevron USA Inc. v. National Resources Defense Council, 467 U.S. 837 (1984).

[6] Xilinx Inc. v. Commissioner, 598 F.3d 1191 (9th Cir. 2010), aff'g, 125 T.C. 37 (2005).