

ALTERA CORP. V. COMMISSIONER: A RARE GOVERNMENT
VICTORY IN TRANSFER PRICING

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I. INTRODUCTION

In late 2017, the Ninth Circuit caused significant disruptions in the Corporate Tax world by reversing the Tax Court’s decision in *Altera Corp. v. Commissioner* and finding that the Commissioner of the IRS could allocate income between related parties without a comparison to

what unrelated parties would do in similar circumstances.¹ In an unusual turn of events, the Ninth Circuit withdrew its opinion after the death of Judge Reinhardt, who was the deciding vote in *Altera*.² This rare withdrawal of an opinion left many individuals eagerly waiting to see whether the Ninth Circuit would maintain its position or concur with the Tax Court on rehearing.

Part II of this article explores how a corporation can take advantage of tax laws to reduce the amount of tax it owes and what government agencies can do to combat these tax avoidance tactics. Part III provides background on *Xilinx v. Commissioner* and examines the opinions of the Tax Court and Ninth Circuit in *Altera Corp. v. Commissioner*. Part IV analyzes *Altera Corp. v. Commissioner* against a backdrop of legislative and judicial history, arguing that the Ninth Circuit did not reach the correct outcome and explores the consequences of the Ninth Circuit's decision. Finally, Part V calls for the Ninth Circuit to reconsider its opinion on rehearing and find that the Tax Court's decision was correct.

II. BACKGROUND

A. Corporate Tax Avoidance

Often, a U.S. Corporation is closely related to a legal entity in a different country, meaning the U.S. entity owns a large part of the foreign entity or they are both part of the same multinational corporation. In some instances, a U.S. Corporation can utilize a tactic called transfer pricing, allowing the U.S. Corporation to shift expenses or profits to a related entity in a country with a lower tax-rate, and thereby avoid paying taxes in the United States.³ One example of this tactic is the transfer of intangible property, and therefore the profits associated with that intangible property, to an entity in a country with lower tax rates than the United States.⁴ This means that the United

1. See *Altera Corp. v. Comm'r (Altera II)*, Nos. 16-70496, 16-70497, 2018 U.S. App. LEXIS 20524 at *4 (9th Cir. July 24, 2018).

2. *Altera Corp. v. Comm'r*, 898 F.3d 1266 (9th Cir. 2018).

3. Cf. David Leonhardt, *The Big Companies That Avoid Taxes*, THE NEW YORK TIMES (Oct. 18, 2016), <https://www.nytimes.com/2016/10/18/opinion/the-big-companies-that-avoid-taxes.html> (last visited Feb. 11, 2019) (explaining how companies like Amazon, Facebook, and Google pay less in corporate taxes by funneling profits through low tax countries).

4. See Xiaoying Zhang, *The Valuation of Intellectual Property for Transfer Pricing Purposes*, LANDSLIDE MAGAZINE (2015), https://www.americanbar.org/content/dam/aba/publications/landslide/2015-september-october/ABA_LAND_v008n01_the_valuation_of_intellectual_property_for_transfer_pricing_purposes_authcheckdam.pdf (last visited Feb. 11, 2019) (explaining how drug manufacturer Pfizer avoided U.S. taxes by shifting intangible property to foreign subsidiary and then paying that subsidiary high licensing fees to offset U.S. profits).

States government is missing out on a significant source of income; some estimate the tax loss for the U.S. government is in excess of 180 billion dollars per year stemming from the use of this tactic.⁵

Google Inc. is a great example of a multinational corporation's ability to reduce tax liability through shifting profits to different countries.⁶ In 2010, Bloomberg News reported that Google's overseas tax rate was 2.4%.⁷ This is astonishing considering Google operates "mostly in high-tax countries where the average corporate rate is well over 20%[,]" including the UK and the United States which had tax rates at the time of 28% and 35%, respectively.⁸ Google was able to reduce its tax rate and save roughly \$3.1 billion dollars in taxes by shifting some of its profits to Bermuda, a country that imposes no tax on corporate profits.⁹

Another opportunity to shift expenses and profits to different countries is through cost-sharing agreements. A United States corporation and its related entity can enter into cost-sharing agreements when collaborating on research and development projects together. The agreement will stipulate that the costs associated with the project will be shared between the parties in proportion to the benefit each party is expecting to receive from the project.¹⁰ A conflict can arise when determining whether certain intangibles, such as stock-based compensation, need to be included in the cost-sharing agreement. Stock-based compensation is any compensation provided to an employee "in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined with reference to) equity instruments or stock options."¹¹

B. The Department of the Treasury's Ability to Allocate Income

To combat the issue of tax avoidance through transfer pricing, the Department of the Treasury ("the Treasury") enacted Section 482 of the Internal Revenue Code ("Section 482"), which allows the Secretary of the Treasury ("the Secretary") to allocate income or expenses between organizations controlled by the same interests if the Secretary

5. Niall McCarthy, *Tax Avoidance Costs the U.S. Nearly \$200 Billion Every Year*, FORBES (Mar. 23, 2017), <https://www.forbes.com/sites/niallmccarthy/2017/03/23/tax-avoidance-costs-the-u-s-nearly-200-billion-every-year-infographic/#1a3853e12f0d> (last visited Feb. 11, 2019).

6. Jesse Drucker, *Move cuts Google Tax Rate to 2.4%*, BLOOMBERG NEWS (October 22, 2010).

7. *Id.*

8. *Id.*

9. *Id.*; *Bermuda Corporate – Taxes on Corporate Income*, PWC WORLDWIDE TAX SUMMARIES, <http://taxsummaries.pwc.com/ID/Bermuda-Corporate-Taxes-on-corporate-income#> (last updated Jan. 23, 2019).

10. Treas. Reg. § 1.482-7A(a)(1) (as amended in 2009).

11. Treas. Reg. § 1.482-7A(d)(2) (as amended in 2009).

determines it is necessary to prevent evasion of taxes.¹² Courts have stated that the purpose of this provision is to provide an income-correction device to prevent artificial shifting of income between related entities.¹³ This provision is further explained by the Treasury Regulation 1.482-1 (“the Regulation”), which gives information about Section 482 and its implementation.¹⁴

1. The Arm’s Length Standard

When determining whether an adjustment to income is proper, “the Commissioner is empowered to examine closely the transactions between controlled taxable entities to determine whether they are such as would have been consummated in an arm’s length negotiation between strangers and to make an allocation when they fail to meet that standard.”¹⁵ In making this determination, the Commissioner has broad discretion and must evaluate the facts of each individual situation.¹⁶ This standard is known as the arm’s length standard and is expressly mentioned in the Regulation itself as well as used in many tax treaties between the U.S. and foreign countries.¹⁷

2. The Commensurate with Income Standard

The arm’s length standard becomes less effective and more difficult to use when dealing with the transfer of intangibles, like stock-based compensation, because there is no concrete way to determine the value of those intangibles at the time of transfer.¹⁸ It is also difficult because there are few, if any, similar transactions between unrelated parties.¹⁹ This led to an amendment to the Regulation and the inclusion of the commensurate with income standard in Section 482.²⁰ Under this standard, “payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possession corporation must be commensurate with the income attributable to the intangible.”²¹

12. I.R.C. § 482 (2018).

13. *Morton-Norwich Products, Inc. v. United States*, 602 F.2d 270, 274 (Ct. Cl. 1979); *see also* *Brittingham v. Commissioner*, 598 F.2d 1375, 1379 (5th Cir. 1979).

14. Treas. Reg. § 1.482-1 (as amended in 2015).

15. *Local Finance Corp. v. Comm’r*, 407 F.2d 629, 632 (7th Cir. 1969).

16. *Id.*

17. Treas. Reg. § 1.482-1(b)(1) (as amended in 2015); *Altera Corp. v. Comm’r*, 145 T.C. 91, 95-96 (T.C. 2015).

18. H.R. Rept. No. 99-426, at 423-26 (1985).

19. *Id.*

20. *Id.*

21. *Id.*

To clarify any confusion stemming from the addition of the commensurate with income standard, the Treasury and the Internal Revenue Service (“the IRS”) published a study in which they concluded that the new standard was meant to work alongside the arm’s length standard.²² This study further stated that the goal of the commensurate with income standard is “to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm’s length transfer of the intangible.”²³

3. Iterations of the Treasury Regulations

i. 1995 Income Tax Regulations

The 1995 income tax regulations provided that costs of intangible developments would be shared but did not expressly mention stock-based compensation.²⁴

ii. Income Tax Regulation 1.482-7A(d)(2)

In 2003 the Treasury amended the Regulation to include section 1.482-7A(d)(2) (“the Rule”).²⁵ The Rule explicitly requires the cost of stock-based compensation to be shared among related entities participating in cost-sharing agreements.²⁶

III. CASES

A. Xilinx Inc. v. Commissioner

In *Xilinx Inc. v. Commissioner*, the Ninth Circuit found that under the 1995 cost-sharing regulations (which did not expressly include stock-based compensation), companies did not have to share stock-based compensation costs because entities operating at an arm’s length would not do so.²⁷

B. Altera Corp. v. Commissioner

In *Altera Corp. v. Comm’r*, the court heard a case where Altera Corp.

22. 1988-49 I.R.B. 7, 1988 IRB LEXIS 3758 at *83-94 (July 1988).

23. *Id.* at *69.

24. *See* *Altera Corp. v. Comm’r (Altera I)*, 145 T.C. 91, 99-101 (T.C. 2015).

25. Treas. Reg. § 1.482-7A(d)(2) (as amended in 2019).

26. *Id.*

27. *Xilinx Inc. v. Comm’r*, 125 T.C. 37, 62 (T.C. 2005).

(“Altera U.S.”) and its Cayman Islands subsidiary, Altera International (collectively “Altera”), challenged the Rule as it applied to sharing costs associated with stock-based compensation.²⁸ Altera U.S. and Altera International had entered into a cost-sharing agreement where they agreed to share the risks and costs of research and development for a project.²⁹ In tax years 2004 through 2007, Altera International paid Altera U.S. a total of \$647,784,201 as a part of this cost-sharing agreement.³⁰ The amount of cash compensation that Altera U.S. paid to employees subject to the cost-sharing agreement was included in the cost pool and, therefore, Altera International paid its share of those costs.³¹ However, not included in the cost pool was the amount that Altera U.S. paid those employees through stock options or other stock-based compensation, as required by the Rule.³² The effect of withholding these additional costs was that Altera International was required to pay Altera U.S. a lower amount, therefore decreasing the income of Altera U.S. and reducing the tax liability owed by Altera U.S. The Commissioner of the IRS notified Altera of this discrepancy and found that Altera International was required to pay Altera U.S. an additional \$80,393,721 for tax years 2004 through 2007.³³ Altera petitioned the Tax Court for a determination that the Rule was invalid.³⁴

1. The Tax Court’s Decision

To determine whether the Rule was valid, the Tax Court had to first understand which standard of review to apply. Under section 706(2)(A) of the Administrative Procedure Act (“the APA”) courts are required to set aside rules that the court finds to be “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.”³⁵ In determining whether a rule is arbitrary and capricious, courts will apply the *State Farm* test and ask whether the agency “engaged in reasoned decisionmaking.”³⁶ The courts have further explained that the reasoned decisionmaking standard requires the agency to look at relevant data and show that the choice made was rationally connected to the facts found.³⁷

28. *Altera I*, 145 T.C. at 92.

29. *Id.* at 93.

30. *Id.* at 94.

31. *Id.* at 93.

32. *Id.*

33. *Altera I*, 145 T.C. at 94.

34. *Id.* at 92.

35. *Id.* at 112.

36. *Id.* at 113 (quoting *Judulang v. Holder*, 565 U.S. 42, 43 (2011)).

37. *Altera I*, 145 T.C. at 113; *Motor Vehicle Mfrs. Ass’n v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 43 (2011).

The Secretary argued that the court should apply the standard articulated in *Chevron U.S.A. Inc. v. Natural Res. Def. Council. Inc.*, but the court did not answer the question of which standard applied, finding that the *Chevron* test included the reasoned decisionmaking standard required by *State Farm*.³⁸ Therefore, the crux of the Tax Court's decision was whether the Treasury reasonably concluded that the Rule was consistent with the arm's length standard and used reasoned decisionmaking to make that determination.³⁹

Altera argued that the Rule was not valid under this standard because (1) it lacked a basis in fact, (2) the Treasury's choice was not rationally connected to the facts, (3) the Treasury did not respond to comments, and (4) there was evidence contrary to the Rule presented to the Treasury.⁴⁰

The Tax Court first examined whether the Rule had a basis in fact by determining whether it was consistent with the arm's length standard.⁴¹ Although the Treasury argued that the court should apply the commensurate with income standard, the court quickly rejected that argument because (1) the commensurate with income standard was meant to work with the arm's length standard and (2) the Treasury did not rely exclusively on the commensurate with income standard when rationalizing the Rule.⁴²

The Treasury argued that the Rule is consistent with the arm's length standard because unrelated parties would include stock-based compensation costs in a cost-sharing agreement.⁴³ The only evidence the Treasury presented to support this contention was its statement in the preamble of the Rule which expressed the belief that these expenses would be included in an agreement between unrelated parties.⁴⁴ The Treasury submitted no findings of fact and conceded that they were unable to find any agreement where unrelated parties agreed to share stock-based compensation costs.⁴⁵

The court ultimately decided that the Rule had no basis in fact because the Treasury did not engage in any fact finding and failed to support its conclusion that unrelated parties would share the cost of stock-based compensation with any evidence.⁴⁶

38. *Altera I*, 145 T.C. at 120.

39. *Id.*

40. *Id.*

41. *Id.* at 122.

42. *Id.* at 121-22.

43. *Altera I*, 145 T.C. at 123.

44. *Id.*

45. *Id.* at 122-23.

46. *Id.* at 125.

The next attack on the Rule's validity was that the Treasury failed to rationally connect its decision to adopt the Rule with the facts on which it relied.⁴⁷ The Treasury noted in the preamble of the Rule that the decision was based on the belief that cost-sharing agreements dealing with the development of high-profit intangibles would include stock-based compensation if those costs were a significant element of employee compensation.⁴⁸ However, the Treasury also failed to refute the fact that many cost-sharing agreements do not deal with high-profit intangibles and that stock-based compensation is not frequently a significant element of compensation.⁴⁹ The Treasury attempted to defend the fact that the Rule did not distinguish these types of agreements by stating that the general rule eased administrative burden.⁵⁰ The court did not find the Treasury's argument persuasive and decided that the failure to differentiate between cost-sharing agreements showed the Treasury did not rationally connect its choice to the facts it relied on.⁵¹

The Tax Court was also required to determine whether the Rule was a legislative rule or an interpretive rule because different administrative requirements apply to each.⁵² Interpretive rules generally explain a law that already exists while legislative rules create a right or obligation and have force of law.⁵³ To have the force of law, Congress must have delegated legislative power to the agency and the agency must have intended to exercise that power.⁵⁴ The agency's intent for a rule to carry the force of law can be inferred if the rule is the only adequate basis for enforcement action or the agency has invoked its general rulemaking authority.⁵⁵

Under section 7805(a) of the Internal Revenue Code, the Secretary is able to create rules and regulations to enforce the Internal Revenue Code, and such rules and regulations carry the force of law.⁵⁶ The court therefore concluded that "Congress has delegated legislative power to the Treasury."⁵⁷ The court further concluded that the Rule was a legislative rule because it was required to adjust the payments made by

47. *Altera I*, 145 T.C. at 125.

48. *Id.*

49. *Id.*

50. *Id.* at 125-26.

51. *Id.* at 126-27.

52. *Altera I*, 145 T.C. at 115.

53. *Id.* at 111.

54. *Id.*

55. *Id.*

56. *Id.* at 116.

57. *Altera I*, 145 T.C. at 116 (quoting *American Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)).

Altera International to Altera U.S., and the Treasury had invoked its general rulemaking authority to promulgate the Rule.⁵⁸ Finding that the Rule is a legislative one is important because the Treasury must comply with additional requirements imposed by section 553 of the APA.⁵⁹ When creating legislative rules an agency must:

(1) publish a notice of proposed rulemaking in the Federal Register; (2) provide “interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation”; and (3) “[a]fter consideration of the relevant matter presented, . . . incorporate in the rules adopted a concise general statement of their basis and purpose.”⁶⁰

The court explained that this requirement was to assist in judicial review and to provide fairness to those affected by the Rule.⁶¹ The court further stated that to comply with the regulation, the Treasury was required to respond to significant comments—failure to do so could be evidence that the decision was not based on a consideration of the facts.⁶² Therefore, the court, as a part of its decision, was required to determine whether the Treasury had complied with the requirements of section 553 of the APA.⁶³

The court concluded that the Treasury had failed to “meaningfully respond to numerous relevant and significant comments.”⁶⁴ In making this determination the court examined the evidence that the Treasury received from commenters such as PricewaterhouseCoopers, KPMG, Deloitte, Baker & McKenzie, American Electronics Association, and others.⁶⁵ These commenters submitted evidence which suggested cost-sharing agreements between unrelated parties rarely included stock-based compensation and that unrelated parties would not be willing to share such costs due the uncertainty of the value.⁶⁶ In its response, the Treasury simply claimed that the agreements which the commenters were referencing were not similar enough to the agreements which were governed by the Rule in question.⁶⁷ The Treasury failed to provide any

58. *Altera I*, 145 T.C. at 116.

59. *Id.* at 111.

60. *Id.* at 111.

61. *Id.* at 112.

62. *Id.*

63. *Altera I*, 145 T.C. at 117.

64. *Id.* at 130.

65. *Id.* at 104-06, 127-28.

66. *Id.* at 129.

67. *Id.* at 130.

analysis on this assertion and did not explain why the differences made the commenters points irrelevant.⁶⁸

Finally, the court found that the Rule was contrary to the evidence before the Treasury.⁶⁹ In coming to this determination the court stated that: (1) the Treasury failed to give any evidence supporting its position, (2) there was a substantial amount of evidence that was counter to the Treasury's position, and (3) the Treasury failed to respond to most of the submitted evidence.⁷⁰

After reviewing the facts and arguments on both sides, the court found the Rule was invalid.⁷¹ The court explained that the Treasury's decision failed to comply with the reasoned decisionmaking standard set forth in *State Farm* and went so far as to say that the decision "epitomizes arbitrary and capricious decisionmaking."⁷²

2. The Ninth Circuit's Reversal

On appeal, the Commissioner argued that the allocation of stock-based compensation costs was proper because it was consistent with the arm's length standard.⁷³ The Commissioner reasoned that, because there were no equivalent uncontrolled arrangements, the commensurate with income method could be used to allocate costs and create an arm's length result.⁷⁴ Altera refuted the notion that the arm's length standard required anything other than a comparability analysis.⁷⁵ Altera therefore claimed that, because unrelated taxpayers would not share stock-based compensation costs, the Commissioner could not require them to share those costs.⁷⁶ In a 2-1 decision, the Ninth Circuit Court of Appeals found for the Commissioner, reversing the Tax Court's opinion and holding that the Rule properly included stock-based compensation in qualified cost sharing agreements.⁷⁷

i. Majority

The Majority took a different approach than the Tax Court and first

68. *Altera I*, 145 T.C. at 130.

69. *Id.* at 131.

70. *Id.*

71. *Id.* at 133.

72. *Id.* at 134 (quoting *Ill. Pub. Telecoms. Ass'n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1977)).

73. *Altera Corp. v. Comm'r (Altera II)*, Nos. 16-70496, 16-70497, 2018 U.S. App. LEXIS 20524 at *7-8 (9th Cir. July 24, 2018).

74. *Id.*

75. *Id.* at 7.

76. *Id.*

77. *Id.* at *4.

examined which standard to use and then determined whether the Treasury's interpretation of the statute was permissible.

ii. Which standard of review applies?

According to the Majority, if the Treasury complied with the APA when creating the Rule, the deferential standard from *Chevron* would apply.⁷⁸ Therefore, the court first determined whether the Treasury complied with the APA when enacting the Rule.⁷⁹

The APA sets forth a rulemaking procedure for agencies and requires, among other things, that they “consider and respond to significant comments received during the period for public comment.”⁸⁰ This requirement, along with others, ensures that the agency's decision was not arbitrary and capricious.⁸¹ The court examined whether the Treasury's decision was arbitrary and capricious in light of the reasoned decisionmaking standard set forth in *State Farm*.⁸² This standard asks the court to determine whether the agency's decision can be rationally connected to the facts it found and requires the agency's path to be reasonable discernable.⁸³

Altera argues that the Treasury failed to satisfy this standard by dismissing comments it received which attacked the Rule for failure to comply with the arm's length standard and gave evidence that unrelated parties would not share stock based compensation costs.⁸⁴ The court dismissed this argument by explaining that the Treasury had in fact not relied on the traditional arm's length standard but had instead used the commensurate with income standard.⁸⁵ In the court's view, the Treasury had given sufficient explanation of its position that the legislative history did not require a comparability analysis and therefore was correct to dismiss the comments.⁸⁶ The disagreement between the commenters and the Treasury regarding which interpretation of the Rule was correct had no bearing on the effectiveness of the rulemaking process.⁸⁷ Rather, the court explained that this disagreement would be

78. *Altera II*, 2018 U.S. App. LEXIS 20524, at *28-29.

79. *Id.* at *29.

80. *Id.* at *29 (quoting *Perez v. Mortgage Bankers Ass'n*, 135 S.Ct. 1199, 1203 (2014)); *see also* 5 U.S.C.A. § 553(c) (Westlaw through P.L. 115-281).

81. 5 U.S.C.A. § 706(2)(A) (Westlaw through P.L. 115-281).

82. *Altera II*, 2018 U.S. App. LEXIS 20524 at *30-31; *see also* *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 52 (2011).

83. *State Farm*, 463 U.S. 29 at 42-44.

84. *Altera II*, 2018 U.S. App. LEXIS 20524 at *31-32.

85. *Id.*

86. *Id.* at *32-33.

87. *Id.* at *35.

“properly addressed in the *Chevron* analysis.”⁸⁸

The court concluded that there was no APA violation because the Treasury’s “path could reasonably be discerned”—the Treasury had given adequate notice of its position that a comparability analysis was not required, had considered the comments submitted, and was justified in rejecting those comments as they had “no bearing on the relevant factors to the rulemaking.”⁸⁹

Altera also argued that abandoning the comparability analysis is a major shift in administrative policy and requires careful consideration and broadcasting of the decision under *FCC v. Fox Television Stations, Inc.*⁹⁰ The court disagreed, finding that the Treasury was not changing a policy, but was clarifying that the existing policy did not require a comparability analysis.⁹¹ Again, the Majority explained that whether this interpretation was permissible would be properly addressed under the *Chevron* analysis and did not lead to a violation of the APA.⁹²

The court therefore concluded that the Rule was not arbitrary and capricious and complied with the APA.⁹³

iii. Deference under Chevron

After determining that the rulemaking process satisfied the requirements under *State Farm*, the court then examined the Treasury’s interpretation of the statute using the *Chevron* analysis.⁹⁴ *Chevron* requires the court to determine whether Congress has spoken to the issue and, if not, asks the court to give deference to an agencies interpretation as long as it is not arbitrary and capricious.⁹⁵

The court found that Section 482 does not speak to whether the Commissioner can require parties to share stock-based compensation costs.⁹⁶ The court further stated that Congress meant to ensure flexibility in the Treasury’s ability to allocate costs to prevent the avoidance of tax liability.⁹⁷

After determining that Congress had not spoken on this issue, the court took a deferential approach to determine whether the Treasury’s

88. *Altera II*, 2018 U.S. App. LEXIS 20524 at *35.

89. *Id.* at **35-36.

90. *Id.* at *39-40; *see also* *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009).

91. *Altera II*, 2018 U.S. App. LEXIS 20524 at *40-41.

92. *Id.*

93. *Id.* at *41.

94. *Id.*

95. *Id.* at *41-42.

96. *Altera II*, 2018 U.S. App. LEXIS 20524 at *43.

97. *Id.*

interpretation was permissible.⁹⁸ The court looked to the purpose of Section 482, which they found to be parity among taxpayers, to determine if the interpretation was permissible.⁹⁹ According to the court, the commensurate with income standard in the 1986 amendment was added because the traditional arm's length standard was not fulfilling this purpose of parity.¹⁰⁰ The Majority examined House and Conference reports associated with the 1986 amendment to determine that the commensurate with income standard was meant to be "purely internal" and therefore abandoning the comparability analysis was not unreasonable.¹⁰¹ The Majority further gleaned from these reports that an arm's length transfer of intangibles between unrelated parties may not be relevant to the allocation of income, and that the Treasury's decision to dismiss comments which provided evidence of such transactions was proper.¹⁰² The court concluded that the Treasury's interpretation of the Rule was not arbitrary and capricious and was permissible under the deferential *Chevron* review.¹⁰³

iv. Altera's Argument

Altera continued to argue that the commensurate with income standard did not change the arm's length standard or do away with the requirement of a comparability analysis.¹⁰⁴ Altera supported this argument by claiming that the court was imposing an "amendment by implication."¹⁰⁵ The court was not persuaded with this argument because the legislative history and the amendment clearly show a change in the meaning of the statute.¹⁰⁶ Furthermore, under Altera's understanding, the commensurate with income standard would be virtually useless because the arm's length standard would always be required.¹⁰⁷

Finally, Altera argued that the Rule is improper under *Xilinx*.¹⁰⁸ The court disagreed, finding that *Xilinx* did not control in this case because

98. *Id.* at *42-43.

99. *Id.* at 44.

100. *Id.*

101. *Altera II*, 2018 U.S. App. LEXIS 20524 at 44; *see also* H.R. Rep. No. 99-426 at 423-35 (1985); H.R. Conf. Rep. No. 99-841 at II-637-38 (1985).

102. *Altera II*, 2018 U.S. App. LEXIS 20524 at *45-47; *see also* H.R. Rep. No. 99-426 at 423-25 (1985).

103. *Altera II*, 2018 U.S. App. LEXIS 20524 at *44-47.

104. *Id.* at *47-48.

105. *Id.* at *48.

106. *Id.*

107. *Id.*

108. *Altera II*, 2018 U.S. App. LEXIS 20524 at *50.

(1) it did not deal with administrative authority and did not mention the commensurate with income standard, and (2) it dealt with a conflict of two rules while this case does not.¹⁰⁹

v. Dissent

Judge O'Malley, in her dissent, took a different view of the relationship between the commensurate with income and the arm's length standards.

Judge O'Malley agreed with the Majority that the purpose of Section 482 was parity among taxpayers.¹¹⁰ O'Malley opined that this purpose was served by the arm's length standard which requires an examination of how uncontrolled taxpayers interact.¹¹¹ The commensurate with income standard, she added, did not supplant the arm's length standard which was to be used in any case in which comparable transactions exist.¹¹²

Judge O'Malley then turned to the treatment of stock-based compensation in previous iterations of the cost sharing regulations.¹¹³ In particular, the 1994 and 1995 regulations included a provision known as the "all costs" provision, which required all costs associated with intangible development to be shared.¹¹⁴ The Tax Court in *Xilinx* found this to include stock-based compensation, which they found to be inconsistent with the arm's length standard.¹¹⁵ The Commissioner in that case never appealed this finding in *Xilinx* and, on appeal, the Ninth Circuit "assumed that sharing expenses related to stock-based compensation would be inconsistent with the arm's length standard."¹¹⁶

Turning to the regulation at issue in this case, O'Malley first examined the Treasury's position in promulgating the rule and in responding to comments.¹¹⁷ The Treasury's position throughout the process was that requiring stock-based compensation costs to be shared was in fact consistent with the arm's length standard.¹¹⁸ The Treasury did not attempt to argue that the commensurate with income standard

109. *Id.* at *50-52.

110. *Id.* at *55. (O'Malley, dissenting).

111. *Id.*

112. *Id.* at *55-56.

113. *Altera II*, 2018 U.S. App. LEXIS 20524 at *57 (O'Malley, dissenting).

114. *Id.*; see also Treas. Reg. § 1.482-1(b)(1) (as amended in 2015).

115. *Altera II*, 2018 U.S. App. LEXIS 20524 at *57-59 (O'Malley, dissenting); *Xilinx, Inc. v. Commissioner*, 125 T.C. 37, 53 (T.C. 2005).

116. *Altera II*, 2018 U.S. App. LEXIS 20524 at *58 (O'Malley, dissenting) (quoting *Xilinx* 598 F.3d at 1194).

117. *Altera II*, 2018 U.S. App. LEXIS 20524 at *63-66 (O'Malley, dissenting).

118. *Id.*

was anything other than consistent with the arm's length standard and noted that comparable transactions would be relevant to this issue.¹¹⁹ The Treasury simply stated that there were no comparable transactions and that parties dealing at an arm's length would include stock-based compensation costs in a cost sharing agreement.¹²⁰ The Tax Court was not persuaded by this position and found the Rule arbitrary and capricious.¹²¹

In Judge O'Malley's view, that the Commissioner did not refute the Tax Court's holding but instead changed its position to argue that the arm's length standard, did not require a comparability analysis.¹²² While the Majority accepted this move from the traditional arm's length standard, Judge O'Malley did not.¹²³ Judge O'Malley opined that *Xilinx* clearly requires a comparability analysis to satisfy the arm's length standard and found that the Treasury made no indication of a change from this standard when promulgating the Rule.¹²⁴ Judge O'Malley therefore found the regulations were invalid under *State Farm* because the Treasury did not give the public notice of its intention to dispose of the traditional arm's length standard and did not respond to the Tax Court's findings that the Treasury failed to provide a reasoned basis for believing that unrelated parties would not share these costs.¹²⁵

3. Ninth Circuit Withdraws Opinion

After the death of Judge Reinhardt, who sided with the majority in *Altera II*, the Ninth Circuit withdrew its opinion to allow for time to confer with the new panel.¹²⁶ Many tax practitioners and business-people are now eagerly waiting to find out if the Ninth Circuit will, under a new panel, make the same determination that it did in *Altera II*, or if they will find that the Tax Court was correct and hold the allocations made by the Treasury as invalid.

119. *Id.*

120. *Id.*

121. *Id.* at *67-67.

122. *Altera II*, 2018 U.S. App. LEXIS 20524 at *67-68 (O'Malley, dissenting).

123. *Id.* at *68-69.

124. *Id.* at *69-70.

125. *Id.* at *71-72.

126. *Id.*

IV. DISCUSSION

A. The Department of the Treasury failed to comply with the APA's rulemaking requirements

The initial issue in *Altera* is whether the Treasury complied with the APA when promulgating Regulation 1.482-7A(d)(2) (“the Rule”), which requires the cost of stock-based compensation to be shared among related entities participating in cost-sharing agreements.¹²⁷

The APA sets out guidelines for administrative rule making and requires “notice of the proposed rule-making, an opportunity for interested persons to comment, and ‘a concise general statement of the basis and purpose’ of the rules ultimately adopted.”¹²⁸ The purpose of these guidelines is, in part, to “provide fair treatment for persons affected by the rule.”¹²⁹ The Tax Court and Ninth Circuit disagreed regarding whether the Treasury adequately gave notice of its intention to move away from the traditional arm’s length standard.¹³⁰ The Tax Court found that although the Treasury mentioned the commensurate with income standard in the Rule, the arm’s length standard was also mentioned and the Treasury showed no intent to move away from the traditional arm’s length approach.¹³¹ The Tax Court relied on language in the preamble to the Rule, which gave the Treasury’s opinion that unrelated parties would in fact share stock based compensation.¹³² As the Tax Court found, this was a clear reference to a comparability analysis and would lead affected parties to believe the traditional arm’s length standard was still an integral part of allocating income.¹³³

In contrast, the Ninth Circuit found that “Treasury communicated its understanding that Congress had called upon it to move away from the traditional arm’s length standard.”¹³⁴ The Ninth Circuit reasoned that the Treasury had sufficiently shown its intent to rely on the commensurate with income standard and had provided enough legislative history to justify its decision.¹³⁵ The Ninth Circuit also cited the preamble to the Rule, which gave the Treasury’s opinion that the commensurate with income standard was consistent with the arm’s length standard and that

127. *Id.*

128. *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977) (quoting 5 U.S.C.A § 553(b)-(c) (Westlaw through P.L. 115-281)).

129. *Home Box Office*, 567 F.2d at 35.

130. *Altera II*, 2018 U.S. App. LEXIS 20524 at *30; *Altera I*, 145 T.C. at 133.

131. *Altera I*, 145 T.C. at 121-22.

132. *Id.* at 109.

133. *Id.* at 121-22.

134. *Altera II*, 2018 U.S. App. LEXIS 20524 at *34.

135. *Id.* at *31-32.

a lack of evidence showing uncontrolled parties would share stock-based compensation costs was insufficient to claim the Rule did not comport with the arm's length standard.¹³⁶ The Ninth Circuit conveniently omitted the latter half of the preamble which discussed in detail how unrelated parties would in fact share stock-based compensation costs.¹³⁷ It is clear that the Treasury was relying, in part, on the commensurate with income standard. It is equally as clear, given the reference to how unrelated parties would engage in similar transactions, that a comparability analysis was meant to be a key point of the allocation of income under the Rule. This leads to a conclusion that the Treasury intended for the commensurate with income standard to work with the traditional arm's length standard and was not meant to supplant a comparability analysis. This is the position taken by Altera and is one that is clearly supported by the preamble to the Rule.¹³⁸

Given that the Treasury gave no notice of its intentions to abandon a comparability analysis, the Treasury did not comply with the APA requirements when promulgating the Rule.¹³⁹ Altera further argues that, even if the Treasury complied with the APA, it does not have the authority to remove a comparability analysis from Section 482 allocations.

B. Section 482 of the Internal Revenue Code requires the use of a comparability analysis

The tax implications of the Ninth Circuit's decision in *Altera* are significant. The court essentially determined that the Commissioner can allocate income between related parties based on a purely internal standard without regard to comparable transactions between unrelated parties.¹⁴⁰ This was substantially different than the Tax Court's opinion, which found comparable transactions between unrelated parties were relevant in its determination that the Rule was invalid.¹⁴¹ This disagreement regarding whether a comparability analysis is required to allocate income is the most significant point at issue in *Altera*. The Ninth Circuit showed as much at rehearing by spending most of the time at oral argument on this issue.¹⁴²

136. *Id.* at *32-34.

137. *Id.*; see also 2003 IRB LEXIS 1858 at 10-12 (showing the full preamble).

138. See *supra* notes 129-134 and accompanying text.

139. See *supra* notes 129-134 and accompanying text.

140. See *supra* notes 84-88 and accompanying text.

141. See *supra* notes 41-50 and accompanying text.

142. Oral Argument, *Altera Corp. v. Comm'r*, (No. 16-70496) (available at <https://www.ca9.uscourts.gov/media/>).

The Commissioner's position is that although the arm's length standard must be applied, it does not necessarily require a comparability analysis. In fact, at oral argument, counsel for the Commissioner stated that even if there were allegedly comparable transactions, those transactions would not be comparable for purposes of income allocation if they did not comport with the commensurate with income requirement.¹⁴³ In contrast, Altera argues that this interpretation of the arm's length standard would completely do away with comparability analyses.¹⁴⁴ Altera's position is that Section 482 first requires a comparability analysis under the arm's length standard and then, if necessary, allows for periodic adjustments so that the transaction comports with the commensurate with income standard. This method, according to Altera, is the only way the arm's length standard and commensurate with income standard can work together.

As the opinions of both the Tax Court and the Ninth Circuit illustrate, determining which view is proper requires a consideration of the purpose of Section 482 and an examination of the legislative history. The parties agree that the purpose of Section 482 is parity but disagree regarding how that purpose must or may be fulfilled. The Supreme Court noted in *Commissioner v. First Sec. Bank* that the purpose of Section 482 was to "place a controlled taxpayer on a tax parity with an uncontrolled taxpayer" and that "the standard to be applied in every case is that of an uncontrolled taxpayer."¹⁴⁵ This language, which has remained largely unchanged, was interpreted to mean that "some evidence of similar business activities between uncontrolled taxpayers must be adduced."¹⁴⁶

Before the addition of the commensurate with income standard in the 1986 amendment, it was widely agreed upon that the allocation of income under Section 482 indeed required a comparability analysis. Taxpayers at that time had argued that, because there was no mention of the arm's length standard in Section 482, the true test should be "what income properly is attributable to each of the two commonly held corporations as its true net income in light of what each performs or produces."¹⁴⁷ The Ninth Circuit at the time disagreed, finding that the proper test is a determination of what income would have resulted "had the dealings been at arm's length between unrelated parties."¹⁴⁸ To be

143. *Id.*

144. *Id.*

145. *Comm'r v. First Security Bank*, 405 U.S. 394, 400 (1972) (quoting Treas. Reg. § 1.482-1(b)(1) (as amended in 2015)).

146. *Luffkin Foundry & Mach. Co. v. Comm'r*, 468 F.2d 805, 808 (5th Cir. 1972).

147. *Oil Base, Inc. v. Commissioner*, 362 F.2d 212, 214 (9th Cir. 1966)

148. *Id.*

sure, in *Frank v. International Canadian Corp.*, the Ninth Circuit had opined that the arm's length standard was not necessarily the sole criterion to be used, but shortly thereafter conditioned this view by stating that it was "under the facts of that case, very narrowly limited."¹⁴⁹ Other courts gave little credence to the holding in *Frank*, finding that "even if the arm's length standard is not the sole criterion, it is certainly the most significant yardstick."¹⁵⁰ A myriad of other cases before the 1986 Amendment show an understanding that a comparability analysis was the primary tool for allocating income.¹⁵¹

In 1986 the commensurate with income requirement was added to Section 482. The Treasury put forth an argument that this new standard was meant to displace the traditional comparability analysis required by the arm's length standard. While its argument is not completely without merit, it neglects significant evidence that a comparability analysis was meant to remain the cornerstone of Section 482. The House Report accompanying the 1986 amendment made it clear that the "effectiveness of the arm's length approach" was under scrutiny with regard to the transfer of intangibles due to the "absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparable."¹⁵² However, the IRS promptly issued a notice, now known as the White Paper, which "present[ed] the findings and recommendations of the [Internal Revenue] Service and Treasury."¹⁵³ The White Paper stated that, although the commensurate with income standard requires adjustments to reflect changes in income, "transfer prices must be determined on the basis of true comparables if they in fact exist."¹⁵⁴ The White Paper went on to state that the commensurate with income standard was consistent with the arm's length standard because it "requires that each entity calculate its profits separately and that related party transactions be priced as if unrelated parties had entered into them."¹⁵⁵ The notice expressly included a comparability analysis within the commensurate with income standard by stating that the "goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that

149. *Frank v. International Canadian Corp.*, 308 F.2d 520, 528-29 (9th Cir. 1962); *Oil Base*, 362 F.2d at 214.

150. *Eli Lilly & Co., v. United States*, 372 F.2d 990, 1000 (Ct. Cl. 1967)

151. See *Local Finance Corp. v. Comm'r*, 407 F.2d 629, 632 (7th Cir. 1969); *Lufkin Foundry*, 468 F.2d at 808; *United Steel Corp. v. Comm'r*, 617 F.2d 942, 947 (2nd Cir. 1980); *Van Dale Corp. v. Comm'r*, 59 T.C. 390, 397-98 (T.C. 1972).

152. H.R. Rep. No. 99-426 at 423-26 (1985).

153. Notice 88-123, 1988 IRB LEXIS 3758 at *1-2.

154. *Id.* at *2.

155. *Id.* at *92.

an unrelated party would earn in an arm's length transfer of the intangible."¹⁵⁶

The view that an allocation under Section 482 requires an analysis of comparable transactions has been maintained through recent years. In 2015 the IRS reiterated that the arm's length standard is satisfied if "the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances."¹⁵⁷ The notice went on to state that the commensurate with income standard could be used to ensure an arm's length result through periodic adjustments.¹⁵⁸ The regulations governing Section 482 show that a comparability analysis is key to the arm's length standard. The regulations provide various methods of determining arm's length results for different categories of transactions.¹⁵⁹ In determining which method to use, the regulations are clear that one of two relevant factors is "the degree of comparability between the controlled transaction and any uncontrolled comparables."¹⁶⁰ The regulations go on to say that when there are "material differences between the controlled and uncontrolled transactions," adjustments can be made based on "commercial practices, economic principles, or statistical analysis."¹⁶¹ This language shows a strong desire to require comparability analyses before allocating income, even when exact comparables do not exist.

Because it is clear that the arm's length standard (which was not supplanted by the commensurate with income standard) is intended to be based on a comparability analysis, the Ninth Circuit's Majority opinion in *Altera* was wrong to allow the Treasury to abandon this standard, especially without giving notice to the taxpayers affected.

Apart from the consequences in the present case, this decision will have significant ramifications for companies in the Ninth Circuit which are parties to cost sharing agreements.¹⁶² Similar to *Altera* U.S., some of these companies have been excluding stock-based compensation from their cost sharing agreements, meaning they could be facing significant

156. *Id.* at *69.

157. 2015 IRB LEXIS 335 at *8-9.

158. *Id.* at *12-13.

159. Treas. Reg. § 1.482-1(b)(2) (as amended 2015); *see also* Treas. Reg. § 1.482-7A (as amended 2013) (providing the methods applicable to cost sharing agreements).

160. Treas. Reg. § 1.482-1(c)(2) (as amended 2015).

161. Treas. Reg. § 1.482-1(d)(2) (as amended 2015).

162. *Ninth Circuit reverses Tax Court in 'Altera,' requires stock-based compensation to be covered by cost sharing payments*, PRICEWATERHOUSECOOPERS' TAX INSIGHTS FROM TRANSFER PRICING (July 27, 2018), <https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-altera-ninth-cir-dec.pdf>.

tax consequences as a result of the Ninth Circuit's decision.¹⁶³ The decision could significantly affect other areas of transfer pricing as well. The Ninth Circuit's rejection of the traditional arm's length standard allows the Treasury to make allocations based on "a hypothetical inquiry" without providing any real evidence to support its claim.¹⁶⁴

V. CONCLUSION

Despite evidence that the Treasury intended to include a comparability analysis as a part of the Rule, the Ninth Circuit improperly found that they had given sufficient notice of their intentions to move away from the traditional arm's length standard.¹⁶⁵ The Tax Court was correct to find that Treasury did not rely entirely on the commensurate with income standard and that the Treasury failed to support its position that sharing stock-based compensation was consistent with the traditional arm's length standard.¹⁶⁶ Furthermore, even assuming that Treasury did in fact comply with the APA, the Ninth Circuit was incorrect to allow Treasury to abandon a comparability analysis which remains an integral part of allocations made under Section 482.¹⁶⁷ The Ninth Circuit ignored a deep history, both legislative and judicial, showing that the commensurate with income standard was not meant to replace a comparability analysis.¹⁶⁸ The Ninth Circuit withdrew its opinion and should use the opportunity to reconsider its position. The Ninth Circuit should concur with the Tax Court in finding that the Treasury did not satisfy the APA's rulemaking requirements and that a comparability analysis is required under the arm's length standard.

163. *Id.*

164. *Id.*

165. *See supra* notes 126-137 and accompanying text.

166. *See supra* notes 126-137 and accompanying text.

167. *See supra* notes 140-162 and accompanying text.

168. *See supra* notes 140-162 and accompanying text.