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No (Tax) Man Is Above the Law: The Tax Court Rejects Final Cost-Sharing Regulations in *Altera Corporation and Subsidiaries v. Commissioner*, 145 T.C. 3 (July 27, 2015)

By Edward L. Froelich

Our 26th President Theodore Roosevelt famously contributed to the American canon the following: "No man is above the law and no man is below it; nor do we ask any man's permission when we ask him to obey it." The notion that no one, not even a powerful federal agency, is above the law is the heart of this case. In *Altera*, the Tax Court addressed the validity of Treasury regulations that required qualified cost-sharing agreements to share stock-based compensation costs. See Treas. Reg. § 1.482-7(d)(2) (August 25, 2003). Altera argued that Treasury ignored certain procedural requirements of the Administrative Procedure Act in the issuance of the final regulations, and therefore the regulations were invalid. The government argued that it did satisfy the APA requirements, and even if it did not any failure was harmless error and the court should defer to the regulations. The Tax Court answered two questions: (1) did the Government observe applicable APA requirements in issuing the final regulations and (2) if not, did such a failure invalidate the regulations? In a reviewed Tax Court opinion, Judge Marvel gave a very clear answer to both questions and in the process exposed the agency's penchant for governance by diktat in this arena.

BACKGROUND AND *XILINX*

A prior Tax Court decision, *Xilinx v. Commissioner*, 125 T.C. 37 (2005), *aff'd* 598 F.3d 1191 (9th Cir. 2010), rejected the IRS's application of pre-2003 section 482 regulations, which required cost-sharing of stock-based compensation. The regulations at issue in *Xilinx* did not specifically identify stock-based compensation as a cost. However, Treas. Reg. § 1.482-7(d)(1), known as the "all costs requirement," provided that controlled parties share all costs relating to intangible product development in a qualified cost-sharing agreement. Thus the IRS could easily argue, based on the broad language of the regulation, that every type of compensation was a cost to be shared. The Ninth Circuit rejected the IRS's application of the all costs requirement because it was contrary to the fundamental principle underlying section 482, i.e., that allocations should be made as if the controlled parties were uncontrolled parties dealing at arm's length. In effect, the Ninth Circuit reconciled the all costs requirement with the arm's length standard, and, because the parties stipulated that uncontrolled parties would not share stock-based compensation costs, the court decided that such costs were not a cost for section 482 purposes. It also opined on temporary regulations that, like those at issue in *Altera*, required stock-based compensation, specifically employee stock options, to be shared:

> It is an open question whether these flaws have been addressed in the new regulations Treasury issued

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after the tax years at issue in this case. See 26 C.F.R. § 1.482-7T(a) & (d)(1)(iii) (2009) (stating explicitly that ESOs are costs that must be shared and that the all costs requirement is an arm's length result).

Those flaws included (i) that an application of the all costs regulation that required costs to be shared that were not shared by uncontrolled parties would undermine the arm's-length standard of section 482 and (ii) that the IRS's position would negate the arm's-length standard expressly incorporated into numerous tax treaties. See our client alert *Ninth Circuit Issues Opinion in Key Transfer Pricing Case: Arm's Length Standard Vindicated* for a fuller discussion of the Ninth Circuit *Xilinx* opinion.

FINAL 2003 REGULATIONS

Treasury issued proposed regulations in 2002. In the notice of proposed rulemaking (NPRM), 67 Fed. Reg. 48997, Treasury stated its intention to clarify the prior cost-sharing regulations to explicitly include stock-based compensation as a cost to be shared and to provide a method for valuing such costs. It thereafter initiated a notice and comment period and appeared interested only in comments "on the clarity of the proposed regulations and how they may be made easier to understand." 67 Fed. Reg at 49001. In other words, the proposition that stock-based compensation costs be shared was not up for discussion. Nonetheless, various parties submitted substantial written comments on the point. Those comments supported the proposition that uncontrolled parties do not share stock-based compensation costs on two general grounds: (i) that there was no evidence uncontrolled parties shared these costs and (ii) that such parties would in fact not share these costs. Despite the comments, Treasury issued final regulations that specifically defined stock-based compensation costs as costs to be shared and that provided two valuation methods for such costs. Treasury did take up the comments in the preamble to the final regulations. It was the nature of Treasury's response that the Tax Court judged to be a critical procedural defect; the court turned to the record of comments to show that Treasury had no evidence for its position and, moreover, that it had dismissed out of hand substantial evidence showing that parties acting at arm's length would not share these types of costs. For the Tax Court this meant that Treasury had not satisfied the "reasoned decision making standard" imposed by the Administrative Procedure Act.

ADMINISTRATIVE PROCEDURE ACT

Congress is sometimes wise and sometimes not. Imposition of notice and comment obligations on agencies through the Administrative Procedure Act was one of those wise moments in which Congress recognized that the more discretionary authority an agency has, the more important it is for it to be accountable to the public. Because federal agency officials are not subject to elections and do not represent a constituency, agencies are made accountable to the public through, among other laws, the APA. Specifically, the APA requires that the issuance of final regulations be preceded by a thoughtful dialogue with the public, and most importantly with that portion of the public directly affected by proposed regulations. The Tax Court focused on section 553 of the APA, which states that when an agency promulgates regulations it must (1) issue a notice of proposed rulemaking, (2) provide interested persons an opportunity to participate in the formulation of the final rules through, e.g., submission of comments and data, and (3) consider the relevant matter presented and incorporate in the final rules a concise statement of their basis and purpose.

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These procedural requirements apply to legislative regulations, i.e., those with the force of law, and not interpretive rules, i.e., those that explain substantive law. Though the government took the position that the 2003 final regulations were interpretive rules it did not provide supporting arguments to the court and instead opted to argue the regulations met the section 553 requirements assuming *ex arguendo* the regulations were legislative. What is interesting about the Government's approach here is that it had already won the argument that Treasury regulations are subject to *Chevron* deference as if they were legislative regulations. *See Mayo Foundation v. United States*, 131 S. Ct. 704 (2011) (rejecting *National Muffler* and holding that the general rule-making authority granted to Treasury under IRC section 7805(a) supports *Chevron* deference for regulation, whether or not there was also a specific grant of rule-making authority in the Code). The Government apparently wanted to keep its options open about the nature of the 2003 final regulations (i.e., interpretive vs. legislative) so as to avoid the requirements of APA section 553 but obtain the benefit of *Chevron* deference. Ultimately, the Tax Court gave the final regulations what amounted to *Chevron* review but found that the regulations were not entitled to deference.

Having satisfied the first two requirements of section 553, Treasury had to persuade the court that it had satisfied the third, regarding consideration of relevant matter and appropriate explanation for the rule. The Tax Court approached its evaluation of this requirement after considering Supreme Court guidance, including *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) and *Judulang v. Holder*, 565 U.S. ___ (2011), which established that "a reviewing court must ensure that the agency engaged in reasoned decisonmaking." Slip op. at 36. Reasoned decisionmaking, according to the Tax Court, means that an agency examined the relevant data and provided a satisfactory explanation for the regulatory action, including a "rational connection between the facts found and the choice made." *Id.* (citing *State Farm*). With this as its starting point, the Tax Court methodically dismantled the Government's arguments.

IS SECTION 482 COST-SHARING SIMPLY CONCEPTUAL?

To avoid *State Farm* the Government argued that implementation of IRC section 482 does not require empirical analysis and, therefore, section 553's requirement to consider relevant data and make a "rational connection between the facts found and the choice made" does not apply. *Id.* at 43. The Government had an uphill battle at best. The Tax Court found plenty of support for the proposition that section 482 allocations at least in part require a factual investigation. Again, the fundamental arm's-length principle is crucial here. To paraphrase, appropriate section 482 allocations are based upon what uncontrolled parties agree to at arm's length, and in the evaluation of a particular taxpayer's transfer pricing method, consideration of arm's length dealings are essential. *Id.* at 43-45. It is true that regulations are not like revenue rulings, which are applications of law to a taxpayer's specific facts; nonetheless, the proposition that a specific category of costs, such as stock-based compensation, be accounted for by taxpayers requires an empirical predicate consistent with the arm's-length standard. In short, do uncontrolled parties actually share these costs? That predicate was not only missing from the preamble, but the drafters of the final regulations felt it was unnecessary to even address the empirical data provided by the commentators:

> Respondent concedes that (1) in adopting the final rule, Treasury took the position that it was not obligated to engage in fact finding or to follow evidence gathering procedures; (2) the files maintained by Treasury relating to the final rule did not contain any empirical or other evidence supporting Treasury's

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> belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs; (3) the files maintained by Treasury relating to the final rule did not have any record that Treasury searched any database that could have contained agreements between unrelated parties; and (4) Treasury was unaware of any written agreement--or of any transaction--between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation.

Id. at 52. From here, the Tax Court found that Treasury could not rationally connect the final cost-sharing rule to the facts. Instead of relying on relevant facts, Treasury relied solely upon its *belief*. *Id.* at 56. Thus, Treasury did not comply with section 553 of the APA because the final rule lacked a basis in fact.[1]

The Government argued in the alternative that the final regulations were based on the "commensurate with income" standard (CWI standard) as a justification independent of the arm's-length principle. Congress included the CWI standard in section 482 in 1986 to require that income relating to the transfer or license of intangible property shall be commensurate with the income attributable to the intangible property. The CWI standard was primarily intended to address the issue of transfers of high-profit potential intangibles between related parties. As was made very clear by Treasury in 1988, Congress intended that the CWI standard be implemented consistent with the "international norm" for transfer pricing, i.e., the arm's-length standard. *Id.* at 13-14. Thus, in evaluating the Government's alternative argument, the Tax Court noted that it was contrary to the preamble, which stated that the final regulations were consistent with the arm's length principle, and to Treasury's own pronouncements that the two standards, arm's-length and commensurate-with-income, are implemented in an integrated manner. *Id.* at 50. In the court's view, Treasury could not in fact rely upon the CWI standard to justify the final rule where the application of that rule would be inconsistent with the arm's-length standard.

FAILURE TO ADEQUATELY RESPOND TO COMMENTS

Section 553 also requires that an agency rationally consider the comments presented. The Tax Court reviewed the record and described several substantive comments all pointing to a lack of evidence to support cost-sharing of stock-based compensation between uncontrolled parties. It noted other comments that provide details about cost-sharing agreements between uncontrolled parties that did not in fact share such costs. Though Treasury did discuss these comments it asserted that the agreements were not comparable to the types of agreements in which stock-based compensation would be shared. However, no explanation was provided in the preamble as to why the agreements were not comparable. *Id.* at 61. Indeed, the Tax Court found that Treasury repeatedly failed to explain how it distinguished empirical data provided in the comments. In the court's view, Treasury simply asserted the data was irrelevant. This failure frustrated judicial review and supported the overall finding that Treasury had failed to engage in reasoned decisionmaking. *Id.* at 65.

WAS TREASURY'S FAILURE TO ADHERE TO THE APA HARMLESS ERROR?

The short answer was no. The Government first argued that Treasury had sufficient alternative bases for the final rule. As already noted, the Government attempted to justify the final rule based on the CWI standard. However,

[1] The Government also argued that the final regulations were an effort to abandon or modify the arm's-length standard. The court noted that nowhere in the preamble was this stated. Id. at 45-46.

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like its failure to explain various distinctions between the data provided and what Treasury considered relevant data, Treasury failed in the preamble to specifically identify the CWI standard or any other alternative grounds as the basis for the final rule. *Id*. at 67. The Government's attempt to appeal to accounting standards that had changed, as a result of the final rule, to require companies to identify stock-based compensation costs was also rejected. In the preamble, Treasury had rejected accounting standards generally as requiring a particular cost-sharing result. The Tax Court ultimately found that, because it was not clear Treasury would have adopted the same final rule had it found that such a rule violated the arm's-length standard, the failure to adhere to the APA procedural requirements was not harmless error. In other words, the Tax Court viewed Treasury's error in rejecting empirical data as integral to the formation of the final rule.

SOME CONCLUDING THOUGHTS

The 2003 final rule is now invalid in the Tax Court. Appeal seems likely, although the Government would have to face the Ninth Circuit, the same bench that decided *Xilinx*. Given the regulatory and litigation history, it is clear that the Government is committed to the rule. Treasury and the IRS could begin another regulatory project in an attempt to address the deficiencies noted by the Tax Court and shoreup the rule. Any such project would need, however, to consider actual market practices versus theoretical constructs, and what practices are apart from financial accounting standards that Treasury and the IRS have generally dismissed as relevant for tax purposes. Companies may have accounted for potential audit adjustments based on the final rule in their FIN 48 reserves and should now revisit whether to maintain those reserves.

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