

CLIENT ALERT

Ninth Circuit Revisits *Altera* and Again Reverses Tax Court

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In *Altera Corporation & Subsidiaries v. Commissioner* (June 7, 2019), the U.S. Court of Appeals for the Ninth Circuit again overturned the U.S. Tax Court and held that a regulation requiring cost sharing of stock-based compensation was valid under the Administrative Procedure Act (APA).

The Ninth Circuit first overruled the Tax Court, and upheld the regulation in question, in July of 2018. The court withdrew its original decision and revisited the case because of the death of one of the judges in the original majority, Circuit Judge Stephen Reinhardt, prior to issuance of the final opinion. In this most recent opinion, Circuit Judge Susan P. Graber replaced Judge Reinhardt and voted in the same way to form a 2-1 majority with Chief Judge Sidney R. Thomas. Overall, the opinion changed very little. Judge Thomas authored both the 2018 and 2019 opinions and upheld the cost sharing of stock-based compensation regulation. As with the 2018 opinion, the court's decision significantly impacts (1) cost sharing, (2) the use of the APA, and (3) transfer pricing generally.

Cost Sharing

The tax issue in the case was whether Altera was required to include stock-based compensation as a cost to be shared in their qualified cost-sharing agreements. The court held the IRS properly required related business entities to include stock-based compensation in their cost-sharing agreements, affirming a regulation adopted to require inclusion of such costs. The regulation overturned a previous decision that stock-based compensation did not have to be included prior to the effective date of the regulation, *Xilinx v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), aff'g, 125 T.C. 37 (2005). As a result, a portion of stock-based compensation costs cannot be deducted from a company's taxable income to the extent those costs are required to be shared and paid by foreign related companies. Altera's tax deficiency was more than \$80 million for the 2004 to 2007 tax years. The requirement to include stock-based compensation, a non-cash cost, in cost-sharing agreements will significantly impact technology companies, which frequently use stock-based compensation.

Administrative Procedure Act

The Tax Court's decision in *Altera* created quite an uproar because the full Tax Court set forth the standards for applying the APA to tax cases, and determined that the adoption of the regulation setting forth the cost-sharing standards did not meet those standards. See [IRS Scores a Resounding Transfer Pricing and APA Win; Ninth Circuit Reverses Tax Court Holding in Altera; Tax Court Strikes Down Treasury Regulation Requiring Cost Sharing of Stock-Based Compensation](#). The Ninth Circuit, while not overturning the general proposition that the APA applies to tax regulations, applied the APA standards much more leniently. The court found that Treasury complied with the procedural requirements when promulgating the regulation in question, and, as a result, that the regulations were valid. Altera originally argued that the IRS ignored relevant comments regarding the regulation, in violation of the APA. The court found the comments to be irrelevant, stating:

Here, Treasury gave sufficient notice of what it intended to do and why, and the submitted comments were irrelevant to the issues Treasury was considering. Because the comments had no bearing on “relevant factors” to the rulemaking, nor any bearing on the final rule, there was no APA violation. 965 F.2d at 771.

Thus, although the APA applies, taxpayers should expect courts to give a high degree of deference to Treasury regulations, and for courts to overturn them only when clearly unsupported. Nevertheless, in appropriate cases, taxpayers should continue to raise APA issues concerning regulations or other IRS guidance, expecting the courts to allow the IRS significant discretion.

Transfer Pricing

Lastly, *Altera* impacts the application of the arm’s-length standard to transfer pricing transactions. *Altera* argued that stock-based compensation could not be included in cost-sharing arrangements, in spite of the regulation, because the evidence showed that parties acting at arm’s length do not do so. *Altera* asserted that the arm’s-length standard required comparability to transactions that occur at arm’s length. The court disagreed, stating: “historically the definition of the arm’s-length standard has been a more fluid one... for most of the twentieth century the arm’s-length standard explicitly permitted the use of flexible methodology in order to achieve an arm’s-length result.” *Altera Corp. v. Commissioner*, 898 F.3d 1266 (9th Cir. 2018), *aff’d*, No. 16-70496, slip op. at 29 (9th Cir. June 7, 2019).

Arguably, the court held that the IRS is not required to use comparable transactions or transfer pricing methods relying on arm’s-length comparisons when allocating income under Section 482. Following *Altera*, the IRS may allocate income in a manner that assures income follows economic activity. Specifically, the court concluded that the addition of the “commensurate with income” sentence to Section 482 in 1986 permits the IRS to reach arm’s-length results without reference to comparable transactions. Although *Altera* will be known for its application of the APA, the court’s conclusions concerning the arm’s-length standard will also have far-reaching consequences.

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