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CLIENT ALERT

Tax Court Strikes Down Treasury Regulation Requiring Cost Sharing of Stock-Based Compensation

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Altera **Decision Expands and Defines Grounds for APA Challenges to Treasury Regulations**

In a July 27, 2015, reviewed opinion, the Tax Court struck down a Treasury regulation that required cost sharing of stock-based compensation. *Altera Corp. v. Comm'r*, 145 T.C. No. 3 (July 27, 2015), was widely viewed as a test case for whether the IRS could require stock-based compensation to be included in cost-sharing arrangements even though parties do not share such costs at arm's length. In addition to being a major transfer pricing victory, the decision confirms that Treasury is required to engage in reasoned decision-making under the Administrative Procedure Act as interpreted in *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), and that the basis for legislative Treasury regulations will be tested based on the information considered by Treasury in promulgating the regulations.

Writing for the Tax Court, Judge Marvel held that under *State Farm*, in adopting Treasury Regulations § 1.482-7(d), Treasury failed to examine the relevant data and failed to articulate a satisfactory explanation for its rulemaking. In the alternative, the Tax Court ruled that this regulation failed *Chevron* Step 2 as being arbitrary and capricious for the same reasons. *See Chevron USA Inc. v. National Resources Defense Council*, 467 U.S. 837 (1984).

The issue in *Altera* was whether stock-based compensation must be included in the research and development costs to be shared in a qualified cost-sharing arrangement under section 482. Section 482 and the regulations thereunder permit the IRS to allocate income to put related parties in the same position for tax purposes as if they were unrelated parties dealing with each other at arm's length.

Altera's U.S. parent and its Cayman Island subsidiary entered into a cost-sharing agreement but did not include in its shared costs stock-based compensation for employees engaged in research and development activities subject to the agreement. The IRS issued a notice of deficiency to include stock-based compensation in the shared cost pool and proposed nearly $80 million of adjustments on this basis.

The Ninth Circuit previously considered this issue in *Xilinx, Inc. v. Comm'r*, 598 F.3d 1191 (9th Cir. 2010), *aff'g*, 125 T.C. 37 (2005), which was based on a prior version of the regulations. Those regulations, promulgated in 1995, required "all costs" associated with development of an intangible be included in the shared cost pool, but did not explicitly state that stock-based compensation must be shared. The Ninth Circuit ruled that under the arm's-length standard of section 482, stock-based compensation would not be shared by unrelated parties and therefore was not required to be shared by related parties in a cost-sharing arrangement, despite the language in the regulation.

The Treasury Department amended the regulations to specifically include "stock-based compensation" in intangible development costs to be shared by cost-sharing agreement participants. Treasury Regulations § 1.482-7(d). In doing so, it issued a notice of proposed rulemaking, received public comments, and held a public hearing. Accounting firms, private parties, and industry groups submitted significant comments, studies, and empirical evidence to show that unrelated parties did not share stock-based compensation in similar agreements, and testimony was submitted at the public hearing on this same basis. Nevertheless, Treasury issued final regulations in 2003 that required stock-based compensation to be included in the cost-sharing pool. T.D. 9088, 2003-2 C.B. 841, 847-48.

In invalidating the stock-based compensation regulation, the Tax Court found that the regulation should be tested based upon whether it was consistent with the arm's-length standard, a factual determination. The Tax Court applied the standard set forth in *State Farm* that the agency must find a "rational connection between the facts found and the choice made." The Tax Court required examination of the reasons for adoption of the rule provided by Treasury in its Treasury Decision, and not later *ad hoc* explanations, citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947).

The Court found that the Treasury's files contained no evidence to support a determination that stock-based compensation must be shared to achieve an arm's-length result. The Court held that the final rule lacked a factual basis because Treasury failed to examine relevant data submitted by commentators, failed to conduct any fact-finding of its own, and failed to support its conclusion in the preamble to the final regulation that unrelated parties would share stock-based compensation costs in a cost-sharing arrangement, concluding: "Treasury's conclusion that the final rule is consistent with the arm's-length standard is contrary to all of the evidence before it."

This decision represents a significant blow to Treasury's repeated efforts to require that stock-based compensation be included in a cost-sharing pool. More generally, the ruling makes it clear that Treasury must carefully comply with the reasoned decision-making requirements of the APA in promulgating tax regulations. Where Treasury receives significant public comments that contradict its proposed rule, it must conduct its own fact-finding or find some other reasoned basis to support a contrary rule, and must substantively respond to significant comments, rather than dismissing them in a conclusory fashion. When it does not do so, the Tax Court will not hesitate to strike down the regulations.

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