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Altera Corp. v. Commissioner: Keeping the IRS at Arm's Length Under §482 and the Administrative Procedure Act

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INTRODUCTION

In *Altera*,[1] the U.S. Tax Court held that Reg. §1.482-7(d), requiring parties to include stock-based compensation in the cost pool to be shared under a cost-sharing arrangement, is invalid. Under *Altera*, taxpayers would not be required to share stock-based compensation in cost-sharing arrangements.[2] The Internal Revenue Service has appealed the *Altera* decision to the Ninth Circuit, which in 2010 upheld the Tax Court's decision, in *Xilinx*,[3] that stock-based compensation is not in fact shared at arm's length and need not be shared under an earlier iteration of the cost-sharing regulations.

In *Altera*, the Tax Court clarified two legal principles that will have long-term effects on the tax laws and tax litigation. First, the court reiterated its position, previously articulated in *Xilinx* and other cases, that the arm's-length standard of Reg. §1.482-1(b)(1) requires an empirical analysis of what unrelated parties would do under comparable circumstances, rejecting Treasury's theoretical approach to §482. Second, the court's analysis of Reg. §1.482-7(d) under the Administrative Procedure Act (APA) followed the Supreme Court's directive to hold Treasury and the IRS to the same reasoned decision-making standard as any other agency, a welcome counterweight to the *Chevron*[4] deference now applicable to tax regulations.

The Tax Court dismissed the IRS's theoretical approach of prescribing how it believed parties should behave at arm's length in the face of factual evidence to the contrary as an ''ipse dixit conclusion'' that ''epitomizes arbitrary and capricious decisionmaking.''[5] The court's endorsement of an empirical, or behavioral approach to applying the arm's-length standard — as opposed to the theoretical constructs of how arm's-length parties ''should'' behave, that Treasury and the IRS advocated — spells trouble for the

[1] *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015). On February 19, 2016, the Internal Revenue Service appealed the *Altera* decision. All section references (''§'') are to the U.S. Internal Revenue Code, as amended (''the Code'') or the Treasury regulations thereunder, unless otherwise indicated.

[2] The Tax Court did not address the current cost-sharing regulations which were adopted in 2011. *See* T.D. 9568 (Dec. 16, 2011). Those regulations, however, also require stock-based compensation to be included in the cost pool for cost-sharing arrangements. *See* Reg. §1.482-7(d)(1)(iii).

[3] *Xilinx, Inc. v. Commissioner*, 125 T.C. 37 (2005), *rev'd*, 567 F.3d 482 (9th Cir. 2009), *withdrawn*, 9th Cir. (2010), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

[4] *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

[5] *See Altera*, 145 T.C. No. 3 at 75 (2015) (citing *Ill. Pub. Telecomms. Ass'n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1997)).

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IRS in future litigation over the application of various intricacies in the modern transfer pricing regulations. As others have observed, the *Altera* decision places the IRS in the difficult position of having to justify its transfer pricing regulations as applications of the behavioral model of the arm's-length standard, when it is apparent that portions of the regulations do not meet that standard.[6]

On the APA issue, *Altera* confirms what *Mayo*,[7] *Home Concrete*,[8] *Cohen*,[9] and *Dominion Resources*,[10] already indicated — tax lawyers now also must be APA experts. The Supreme Court stated in *Mayo*:

> We are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly ''recogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.''[11]

In *Altera*, the Tax Court fully embraced *Mayo's* admonition, and confirmed that the administrative review applicable to tax law will include the full history of Administrative Procedure Act litigation, particularly the long history of review of administrative actions under the ''hard look'' standards articulated in *State Farm*.[12] The *Altera* court effectively recognized the cumulative current status of almost 70 years of APA litigation as now applicable to tax cases. The court's robust application of the APA is sure to have far-reaching implications for a broad range of tax litigations.

SUMMARY OF POINTS

As a transfer pricing case, *Altera* teaches us:

- Facts are hard. Once taxpayers established that, as a factual matter, non-controlled parties in cost-sharing arrangements do not share the costs of stock-based compensation, it became extremely difficult for the IRS to prevail.
- Treasury's regulatory power does not extend to regulating based on factual premises that are contradicted by the record. In 2003, Treasury promulgated regulations under Reg. §1.482-1(b)(2) and §1.482-7(d)(1) to backstop its position on cost-sharing arrangements. Although the changes clarified (or perhaps changed) Treasury's intended meaning of the regulations, in promulgating the regulations Treasury did not adequately address the facts submitted in comments to the proposed regulations, and later reiterated in *Xilinx*, that parties do not share costs of stock-based compensation in actual arm's-length arrangements. Accordingly, the taxpayer prevailed again in *Altera*, as in *Xilinx*.
- The arm's-length standard of Reg. §1.482-1(b) is first among equals when it comes to interpreting the transfer pricing regulations. It is incorporated in the U.S. treaty network and the OECD model treaty. The IRS and Treasury have repeatedly argued that the transfer pricing regulations implement the arm's-length standard. The courts look to the arm's-length standard as the expression of the overall ''purpose'' of the transfer pricing regulations.[13]
- The arm's-length standard contemplates an empirical analysis of how uncontrolled taxpayers transact. The IRS approach of treating the arm's-length standard as a theoretical construct, through which ''arm's-length results'' can be deduced without the necessity of accounting for the facts observed from actual arm's-length transactions, is doomed to failure. The IRS can be forgiven for engaging in the intellectual pursuit of a perfect transfer pricing theory; many economists and lawyers do the same. Nevertheless, it is a mistake.
- The IRS cannot escape the arm's-length standard by arguing that controlled parties have distinct incentives from unrelated parties. The IRS has argued that the differences in incentives among controlled parties as compared to uncontrolled parties amount to differences in circumstances, which justifies the IRS holding controlled parties to rules that differ from the basic arm's-length standard. This argument has failed repeatedly.
- The IRS needs to decide what it is doing when it is prescriptive in its regulations. Is it granting a safe harbor, for which it can set the rules? Or is it trying to tell taxpayers and the courts what is ''arm's length''? The cost-sharing regulations currently purport to prescribe the characteristics of a

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[6] *See* M. Schler, *The Arm's Length Standard After Altera and BEPS*, Tax Notes (Nov. 30, 2015).

[7] *Mayo Found. for Med. Educ. & Res. v. United States*, 131 S. Ct. 704 (2011).

[8] *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012).

[9] *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011).

[10] *Dominion Res., Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012).

[11] *Mayo*, 131 S. Ct. at 713.

[12] *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

[13] Commentators have observed that the transfer pricing regulations often are more consistent with clear reflection principles from the arm's-length standard. *See* M. Schler, *The Arm's-Length Standard After Altera and BEPS*.

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"cost-sharing arrangement."[14] Prior versions of the regulations have purported to prescribe the characteristics that an arrangement must meet to be treated as a "qualified cost-sharing arrangement."[15]

- Although the regulations are written in such a way as to allow the IRS discretion to treat a controlled transaction as a cost-sharing arrangement, they do not appear to recognize the validity of controlled cost-sharing arrangements that, although they fail one or more of the IRS's prescribed criteria, are consistent with arm's-length cost-sharing behavior.[16] This is troubling because, as the Tax Court observed in *Altera*, "sec. 482 purports only to empower the Secretary to allocate income among controlled entities but not to directly govern taxpayer conduct."[17]

As an Administrative Procedures Act case, *Altera* shows us the following:

- After *Mayo*, *Home Concrete*, and now *Altera*, we know that most Treasury regulations are legislative regulations, subject to *Chevron* deference, including those promulgated pursuant to §7805, Treasury's general grant of rulemaking authority. We also know, however, under *Altera* and *Dominion Resources*,[18] that those regulations are subject to the notice and comment requirements of the APA and the reasoned decision-making standard of *State Farm*.
- In promulgating a legislative regulation, Treasury must provide some explanation of the basis of the regulation, and that explanation must address substantive comments that were submitted. Legislative regulations will be tested based upon what Treasury said at the time, not *post-hoc* rationalizations presented to the court.[19]
- The conclusion in *Altera* that legislative regulations that receive *Chevron* deference are also subject to *State Farm* "hard look" review imposes a procedural burden on Treasury which, because it applies to existing regulations and is based on the procedures and explanations at the time the regulations were adopted, cannot currently be cured. Ironically, in some cases such as *Altera*, the IRS's successful campaign to achieve *Chevron* deference for Treasury regulations has backfired.
- The taxpayer's challenge to the cost-sharing regulations at issue in *Altera* had the advantage of a carefully developed administrative record of substantive comments that presented factual evidence undermining the conclusions in the regulations. Taxpayers considering challenges to other regulations must consider the administrative records for their regulations carefully. For regulations adopted under §482, the stronger challenge still may be based on inconsistency of a regulation with the behavioral arm's-length standard, such as was successful in *Xilinx* and *Altera*.

BACKGROUND ON COST-SHARING/ STOCK-BASED COMPENSATION ISSUE

In *Altera*, the Tax Court, in a reviewed opinion, held the 2003 cost-sharing regulation requiring that stock-based compensation be included in the pool of shared costs was invalid under the APA. These regulations were a much debated directive from Treasury and the IRS. Treasury and IRS have amended the cost-sharing regulations six times since the 1986 Act.[20] In addition, the Tax Court has taken up the issue of whether stock-based compensation must be included in the pool of shared costs under a cost-sharing arrangement three times: in *Seagate*,[21] *Xilinx*, and *Altera*.

Evolution of the Cost-Sharing Regulations

Prior to 1986 Act, the regulation addressing cost-sharing arrangements was contained in Reg. §1.482-2(d)(4), which stated:

> In order for [a cost-sharing] arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's-length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those

[14] *See* Reg. §1.482-7(b) ("An arrangement is a CSA if and only if the requirements of paragraphs (b)(1) through (b)(4) of this section are met.").

[15] *See, e.g.,* Reg. §1.482-7A(a)(1) ("A taxpayer may claim that a cost-sharing arrangement is a qualified cost-sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section.").

[16] *See* Reg. §1.482-7(b)(5)(ii).

[17] *Altera*, 145 T.C. No. 3, at 72 n. 23.

[18] *See Dominion Res.*, 681 F.3d at 1319.

[19] *Altera* at 65 (citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947) and *Carpenter Family Invs., LLC v. Commissioner*, 136 T.C. 373, 380, 396 n. 30 (2011)).

[20] These amendments were in 1996 (T.D. 8670), 2000 (T.D. 8930), 2003 (T.D. 9088), 2008 (T.D. 9441), 2011 (T.D. 9569), and 2013 (T.D. 9630).

[21] *Seagate Tech., Inc. v. Commissioner*, T.C. Memo 2000-388.

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which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. . . .[22]

In the Conference Report to the 1986 Act, which added the commensurate-with-income standard, the Committee endorsed the continued use of cost-sharing arrangements. ''In revising section 482, the conferees do not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties . . . .''[23] The Conference Committee went on to state, ''Under such a bona fide cost-sharing arrangement, the cost sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development stages would be included.''[24]

In its 1988 Study of Intercompany Pricing (''1988 White Paper''), the IRS followed Congress's lead by endorsing the arm's-length nature of cost-sharing arrangements. It stated that ''cost-sharing arrangements have long existed at arm's length between unrelated parties,'' but acknowledged that ''[t]he Service has little experience with ordinary unrelated party cost-sharing arrangements . . . .'' The IRS asked commenters to submit information on both controlled-party and uncontrolled-party cost-sharing arrangements.[25]

Notwithstanding the acknowledgement that cost-sharing arrangements occur at arm's length and the requests for information on such arm's-length arrangements, Treasury identified potential areas of concern for controlled-party cost-sharing arrangements. Its solution was to adopt a prescriptive approach to allowing cost-sharing arrangements under the transfer pricing regulations. The 1988 White Paper's discussion of cost-sharing arrangements identified three broad areas of concern: (i) selective inclusion of high-profit potential intangibles in cost-sharing arrangements, (ii) the need to ensure that the shares of costs are proportional to the shares of anticipated benefits, and (iii) the buy-in.[26] The IRS proposed solutions to these issues by setting up a general rubric for a ''bona fide cost-sharing agreement.'' For example, the IRS suggested requiring the scope of a cost-sharing arrangement to encompass a three-digit SIC code as a way to avoid selective inclusion issues, and requiring assignment of specific geographic rights to the developed intangibles as a means to avoid the reasonably anticipated benefit share problem.[27] Arrangements that did not fit the IRS's bona fide cost-sharing arrangement rubric, the 1988 White Paper argued, should not be analyzed under the cost-sharing regulation.[28]

With respect to the pool of shared costs, the 1988 White Paper simply stated:

> In general, the costs to be shared should include all direct and indirect costs of the research and development undertaken as part of the arrangement. Direct expenses would include expenses for salaries, research materials, and facilities. . . . Indirect costs should include a portion of overall corporate management expense and overall interest expense that is allocated and apportioned to research and development activities in a manner consistent with U.S. expense allocation principles.[29]

In 1992, Treasury proposed amendments to the transfer pricing regulations, including for cost-sharing arrangements, which adopted the prescriptive approach to determining which cost-sharing arrangements met the ''arm's-length'' standard. The preamble to the proposed regulations reviewed the legislative history to the 1986 Act and the 1988 White Paper and stated: ''The White paper concluded that cost-sharing arrangements should have standard terms.'' It repeated the White Paper examples, that cost-sharing arrangements should have sufficient scope to cover products within a three-digit SIC code, and that participants should be assigned exclusive rights to the developed intangibles. The preamble noted that commentators maintained that the approach in the 1988 White Paper would ''unduly restrict the ability of taxpayers to en-

[22] Reg. §1.482-2(d)(4) (1968).

[23] H.R. Rep. No. 99-841, Vol. II, at II-638 (Sept. 18, 1986); *see also* Jt. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986 (May 4, 1987) (hereinafter ''1986 Blue Book''), at 1017.

[24] H.R. Rep. No. 99-841, Vol. II, at II-638; 1986 Blue Book at 1017.

[25] *See* 1988 White Paper at 109; *see also id.* at Appendix p. 13 (IRS auditors observed related-party cost-sharing arrangements in 17.5% of cases).

[26] 1988 White Paper at 114.

[27] 1988 White Paper at 127.

[28] 1988 White Paper at 115 (''While section 1.482-2(d)(4) limits adjustments by the Service in the context of cost-sharing arrangements to an adjustment of contributions paid, this regulation presupposes that the arrangement is bona fide. If the arrangement is not bona fide, normal arm's length standards would apply, including the commensurate with income standard.'').

[29] 1988 White Paper at 120–21; *see also id.* at 128 (''The costs to be shared should include all direct and indirect costs determined in a manner consistent with U.S. tax accounting and expense allocation principles.'').

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ter into cost-sharing arrangements.''[30] The proposed regulations nevertheless adopted the approach that only a ''qualified cost-sharing arrangement'' would limit the IRS's discretion to adjusting the cost shares (as opposed to imposing a royalty).[31]

As the cost-sharing regulations have gone through additional iterations and become ever more complex, they have preserved both the position that cost-sharing arrangements are based on arm's-length transactions and the prescriptive approach to defining cost-sharing arrangements. Under this prescriptive approach, the regulations purport to define a ''cost-sharing arrangement'' as a contract that meets specific requirements that are spelled out in the regulations.[32] The regulations permit the IRS, but not taxpayers, to treat non-conforming arrangements as cost-sharing arrangements, if the IRS concludes that the cost-sharing regulations provide the most reliable measure of an arm's-length result.[33] These regulations read like a safe harbor election with no possibility of the taxpayer pursuing a ''facts and circumstances'' approach to proving that its non-safe-harbor transaction is consistent with arm's-length behavior.[34]

Taxpayers Have Challenged the IRS's Prescriptive Approach to Identifying When Cost-Sharing Arrangements Are ''Arm's-Length''

In a series of cases, taxpayers challenged the IRS's prescriptive approach in determining which cost-sharing arrangements were arm's-length. When the courts pointed out that the prescriptive approach was fundamentally inconsistent with the arm's-length standard, Treasury and the IRS responded with ever-more prescriptive regulations. Ultimately, in *Altera*, the court soundly rejected the prescriptive approach. As long as the IRS takes the position that it can apply the arm's-length standard, which the courts interpret as a behavioral standard that looks to actual third-party transactions, by using such prescriptive regulations, the IRS will continue to lose these cases.

Seagate Technology Inc. v. Commissioner

In *Seagate*, the Tax Court (Judge Gerber) considered the taxpayer's motion for summary judgment on the issue of whether the 1968 cost-sharing regulations[35] required inclusion of stock-based compensation in the pool of shared costs. The court denied the motion and set for trial the issue of whether the sharing of stock-based compensation costs is a circumstance comparable to those which would have been adopted by unrelated parties.[36] The case settled before trial.

The 1990 transfer pricing regulations provided that a cost-sharing arrangement would be considered arm's-length ''where the terms and conditions . . . [are] comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.''[37] Seagate argued that, under the regulations, the IRS needed a ''factual predicate'' before making a cost allocation. It also asserted that the IRS had no evidence that uncontrolled taxpayers share stock-based compensation as a cost when engaged in cost-sharing arrangements for research and development.

The IRS was, in fact, unable to come up with any evidence that uncontrolled parties actually share stock-based compensation when engaged in cost-sharing arrangements. Instead, it offered expert opinion testimony that stock-based compensation ''should'' be shared among uncontrolled parties in a cost-sharing arrangement.[38] For its part, Seagate asserted that uncontrolled parties do not share stock-based compensation costs and offered affidavits to that effect from a number of its officers. Seagate also noted that the Federal Acquisition Regulations (FAR) do not permit government contractors to include stock-based compensation as a cost in a ''cost plus'' contract.

In its decision denying the taxpayer's summary judgment motion, the Tax Court opined that, although the IRS did not need to come up with an actual example of an arm's-length transaction as a prerequisite to making an allocation under the regulations, it could not ignore evidence that uncontrolled parties do not share stock-based compensation. ''There is no specific

[30] *See* Notice of Proposed Rulemaking INTL-372-88 (Feb. 24, 1992), *reprinted in* 1992-1 C.B. 1164, 1165.

[31] *See id.* at 1992-1 C.B. 1164, 1169.

[32] *See, e.g.,* Reg. §1.482-7(b) (setting forth substantive and procedural requirements for a ''cost-sharing arrangement'').

[33] *See, e.g.,* Reg. §1.482-7(b)(5)(ii) (Commissioner may deem non-conforming arrangements ''cost-sharing arrangements'').

[34] *Compare* Reg. §1.482-7(b) *with* Reg. §1.482-9(b) (taxpayers may elect services cost method) *and* Reg. §1.901-2A(c) (allowing taxpayers to prove foreign levy is a tax based on safe harbor and facts-and-circumstances methods).

[35] During the years at issue, 1990 through 1992, the cost-sharing regulation was contained in Reg. §1.482-2(d)(4), quoted above.

[36] *Seagate*, T.C. Memo 2000-388, 2000 T.C. Memo (RIA) at 2277. The court also tried the issue of whether SBC has any cost to the taxpayer.

[37] *Id.* at 2275 (*quoting* Reg. §1.482-2(d)(4) (1990)).

[38] The Tax Court observed that ''for better or worse, expert witnesses have become the prognosticators and the bane of transfer pricing cases.'' *Seagate*, T.C. Memo 2000-388, 2000 T.C. Memo (RIA) at 2277.

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minimum standard prerequisite to the Commissioner's determination that an allocation should be made. Such a determination, however, may ultimately be found to be arbitrary, capricious, or unreasonable.''[39]

Ultimately, the court explained, its inquiry would be directed to ''whether the sharing of stock option costs is a circumstance 'comparable to those which would have been adopted by unrelated parties.' ''[40] It ordered a trial on the question of whether arm's-length parties to a similar transaction would share the cost of stock-based compensation. The parties then settled.[41]

Xilinx Inc. v. Commissioner

Tax Court Holds That Empirical Evidence of the Behavior of Uncontrolled Parties Is Outcome Determinative Under the Arm's-Length Standard

The *Xilinx* case involved a 1995 cost-sharing arrangement between Xilinx U.S., a manufacturer of integrated circuits and software, and its Irish affiliate (Xilinx Ireland). Under their cost-sharing arrangement, Xilinx U.S. and Xilinx Ireland agreed to share the direct and indirect costs of developing new technology in proportion to their reasonably anticipated shares of the benefits from exploitation of the new technology.[42] However, the cost-sharing arrangement did not address whether stock-based compensation was includible in the pool of shared costs. Xilinx U.S. paid stock-based compensation to its employees in the United States. Xilinx Ireland also paid its employees stock-based compensation pursuant to an agreement under which it paid Xilinx U.S. for the ''cost'' of stock option exercises by Xilinx Ireland employees.[43] Xilinx U.S. deducted its stock-based compensation and included a portion in its R&D tax credit computations for the years 1997–1999.[44]

The IRS took the position that Xilinx should have included stock-based compensation in the pool of shared costs under the cost-sharing arrangement. Because the vast majority of the stock-based compensation was for Xilinx U.S. employees, the effect of this adjustment would have been to reduce Xilinx U.S.'s §83 deductions, resulting in significant U.S. tax deficiencies and penalties.[45] Xilinx petitioned the Tax Court. Following stipulations, the parties filed cross-motions for summary judgment, which the Tax Court denied. In its ruling, the court found that the IRS had not established that stock-based compensation was a cost, and Xilinx had not disproved that stock-based compensation was a cost.[46] It also addressed the question of whether, under the general arm's-length standard of the regulations, a showing that unrelated parties would not share stock-based compensation would undermine the basis for the IRS's notice of deficiency:

> Section 1.482-1(b)(2), Income Tax Regs., does not require respondent to have actual knowledge of an arm's-length transaction as a prerequisite to determining that an allocation should be made. *See Seagate Technology, Inc. v. Commissioner*, T.C. Memo 2000-388. If, however, it is established that uncontrolled parties would not share [stock-based compensation], we may conclude that respondent's determination is arbitrary, capricious, or unreasonable.[47]

The court denied summary judgment because neither party had presented sufficient evidence on this issue of actual arm's-length behavior.

Following trial, the Tax Court (Judge Foley) rendered a decision for Xilinx. The Tax Court opinion found, as undisputed facts, (i) the lack of comparable uncontrolled cost-sharing transactions in which the parties agreed to share stock-based compensation as costs, and (ii) that unrelated parties would not explicitly share the costs of stock-based compensation in an uncontrolled cost-sharing arrangement.[48] These empirical facts about the behavior of uncontrolled parties

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[39] *Seagate*, T.C. Memo 2000-388, 2000 T.C. Memo (RIA) at 2276.

[40] *Id.* at 2277 (*quoting* Reg. §1.482-2(d)(4) (1990)).

[41] *Seagate*, T.C. Memo 2000-388, 2000 T.C. Memo (RIA) at 2277. It also set trial on whether the stock-based compensation had any cost to Seagate.

[42] *See* Reg. §1.482-7(a)(1) (1997).

[43] Xilinx Ireland agreed to pay Xilinx U.S. the difference between the market price on the date of exercise by a Xilinx Ireland employee and the exercise price for that employee. These Xilinx Ireland stock-based compensation ''cost'' reimbursements were relatively small: $402,978 for 1997, $243,094 for 1998, and $808,059 for 1999. *Xilinx*, 598 F.3d at 1193.

[44] Xilinx U.S. deducted $177 million in stock-based compensation, and included approximately $84 million of SBC in its R&D tax credit computations over the years 1997, 1998, and 1999.

[45] The IRS initially asserted deficiencies and penalties as follows:

Year	Deficiency	Penalty
1996	$24,653,660	$4,935,813
1997	25,930,531	5,189,389
1998	27,857,516	5,573,412
1999	27,243,975	5,448,795

The IRS later filed an amended answer that reduced, slightly, the alleged deficiencies based on a new ''grant date'' valuation method for stock-based compensation. The 1996 year was resolved by stipulation. *Xilinx*, 125 T.C. at 47, 51.

[46] *Xilinx*, 125 T.C. at 48.

[47] *Id.* (quoting summary judgment denial).

[48] *See Xilinx*, 125 T.C. at 54, 58–59.

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to cost-sharing arrangements were outcome determinative.

In light of the factual findings about the behavior of uncontrolled parties, the Tax Court put aside the question of whether Xilinx's stock-based compensation was a ''cost'' under the cost-sharing regulations. Instead, the court focused on whether the IRS had authority under the regulations to deem a particular result to be consistent with the arm's-length standard, even if the deemed result was inconsistent with the empirical facts of uncontrolled transactions.

The Tax Court explained that the arm's-length standard of the regulations limits the IRS's discretion in making transfer pricing adjustments. Although Code §482 grants the Commissioner broad discretion to allocate income, deductions, and credits, Reg. §1.482-1 constrains that discretion by imposing ''general principles and guidelines to be followed under section 482.''[49] In particular, Reg. §1.482-1(b)(1) states that ''the standard to be applied in *every case* is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.''[50]

The IRS argued that the arm's-length standard in Reg. §1.482-1(b) allows for exceptions, and it cited the cost-sharing regulations as an example of an exception. The IRS further argued that Congress endorsed making this exception in the legislative history to the 1986 Act, which added the commensurate-with-income standard to Code §482.[51]

The Tax Court rejected the IRS's argument for exceptions to the arm's-length standard. First, the court observed that the IRS position was based on a prescriptive approach to identifying arm's-length arrangements rather than on empirical evidence of how arm's-length parties actually transact. ''Respondent offers no evidence or testimony establishing that his determinations are arm's length. He simply contends that the 'application of the express terms of Reg. §1.482-7 itself produces an arm's-length result,' and that 'it is unnecessary to perform any type of comparability analysis to determine . . . whether parties at arm's length would share [stock-based compensation.]' ''[52] Then, the court held that the regulations did not support a prescriptive approach but instead require such an empirical analysis. ''The regulation does not state that any allocation proposed by respondent automatically produces an arm's-length result without regard to what arm's-length parties would do. Therefore, respondent's litigating position is contrary to his regulations.''[53]

The Tax Court also rejected the IRS's argument that Congress intended to create exceptions to the arm's-length standard through the 1986 Act. The IRS argued that the legislative history's discussion of cost-sharing arrangements revealed a Congressional intent to move from using comparable uncontrolled transactions to using internal measures of profit or cost. The court held that it need not look to legislative history because Reg. §1.482-1(b)(1), as promulgated after the 1986 Act, was unambiguous.[54] In addition, it held that, even if the legislative history were relevant, the legislative and regulatory history supported application of a behavioral, empirical application of the arm's-length standard.[55]

> The arm's-length standard is included without exception, and the 1986 modification of section 482 did not eliminate the use of comparable transactions in determining a controlled taxpayer's income. . . . Cost sharing determinations . . . are not exempted. Accordingly, if unrelated parties would not share [stock-based compensation], respondent's determinations are arbitrary and capricious.[56]

In sum, the Tax Court found as a fact that uncontrolled parties do not share stock-based compensation as a cost when entering cost-sharing arrangements. The court held that these empirical facts about the behavior of uncontrolled parties were outcome determinative under the arm's-length standards of Reg. §1.482-1(b)(1).[57] As described below, the empirical facts about arm's-length behavior also were critical to the later decision in *Altera*.

Ninth Circuit Initially Reverses Tax Court

The *Xilinx* appeal was procedurally very interesting. The case went to the Ninth Circuit, which ini-

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[49] *See id.* at 53 (*quoting* Reg. §1.482-1(a)(1)).

[50] *See Xilinx*, 125 T.C. at 54 (*quoting* Reg. §1.482-1(b)(1)) (emphasis added).

[51] *See id.* at 54.

[52] *See id.*

[53] The Tax Court described an IRS position contrary to its regulations as ''capricious application of the law.'' *See Xilinx*, 125 T.C. at 55 (*quoting Phillips v. Commissioner*, 88 T.C. 529, 534 (1987)).

[54] *See Xilinx*, 125 T.C. at 55–56.

[55] *See id.* at 57 (''Neither the 1992 nor 1995 regulations contain language indicting any intention to remove the arm's-length standard with respect to cost-sharing determinations or prevent consideration of uncontrolled transactions.'')

[56] *See id.* at 58.

[57] Indeed, the Tax Court held that the controlled parties' actual transactions, which required Xilinx Ireland to compensate Xilinx U.S. for the ''cost'' of SBC granted to Xilinx Ireland employees was irrelevant. It reasoned that this actual behavior of the related parties was irrelevant because Reg. §1.482-1(b) looks to transactions between unrelated, not related, parties. *See Xilinx*, 125 T.C. at 61 n. 14.

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tially issued a 2-1 decision reversing the Tax Court and ruling for the IRS. Judge Fisher authored the initial majority opinion. In light of the empirical fact, established in the Tax Court trial, that arm's-length parties do not share stock-based compensation when engaged in cost-sharing arrangements, Judge Fisher determined that there was a conflict between the general arm's-length standard of Reg. §1.482-1(b)(1), which he also read to measure controlled transactions against empirical facts about the behaviors of uncontrolled parties, and the requirement to share ''all costs'' of the intangible development activity under Reg. §1.482-7(d)(1).

> Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's length would behave. The language is unequivocal: this arm's length standard is to be applied ''in every case.'' In the context of cost-sharing agreements, this would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, §1.482-7(d)(1) specifies that controlled parties in a cost-sharing agreement must share *all* ''costs . . . related to the intangible development area,'' and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision's plain language mandates a different result.[58]

Both the IRS and Xilinx argued that the empirical arm's-length standard and the prescriptive cost-sharing regulations could be harmonized, but Judge Fisher rejected these arguments. Xilinx argued that the cost-sharing regulations should be read to implicitly incorporate the general arm's-length standard, so that Reg. §1.482-7(d)(1) only required costs to be included in the pool of shared costs if arm's-length parties would share them. The IRS argued that the word ''generally'' in Reg. §1.482-1(b)(1) means there are exceptions to using ''the results of comparable transactions under comparable circumstances'' to determine the arm's-length result and that the all costs requirement in Reg. §1.482-7(d)(1) is such an exception. Judge Fisher rejected both harmonization arguments, stating ''If unrelated parties operating at arm's length would not share the [stock-based compensation] cost, requiring controlled parties to share it is simply not an arm's length result.''[59]

Faced with this conflict between Reg. §1.482-1(b)(1) and §1.482-7(d)(1) on the treatment of stock-based compensation, Judge Fisher's initial opinion applied the canon of construction under which the more specific rule governs over the more general. Reasoning that the ''all costs'' rule of Reg. §1.482-7(d)(1) was part of the regulation specifically addressing cost-sharing arrangements, Judge Fisher found that rule governed. Accordingly, he held for the IRS and reversed and remanded the case to the Tax Court.[60]

The Ninth Circuit Reverses Course and Affirms the Tax Court

The Ninth Circuit's initial opinion in *Xilinx* drew outcries from the tax bar, former Treasury and IRS officials, and U.S. treaty partners, who argued that the opinion damaged the arm's-length standard and was inconsistent with U.S. treaty obligations. Moreover, even the IRS declined to endorse Judge Fisher's reasoning. When Xilinx moved for rehearing, the IRS response argued that Judge Fisher reached the right result, but his reasoning was flawed. The Ninth Circuit granted a rehearing and withdrew its initial opinion, and shortly thereafter issued a new opinion ruling in favor of Xilinx. Judge Noonan, who had dissented in the initial opinion, wrote for the majority. Judge Fisher, who reversed his vote, issued a concurring opinion.

Judge Noonan also reasoned that, in light of the established fact that unrelated parties do not share stock-based compensation in their cost-sharing arrangements, the general arm's-length standard of Reg. §1.482-1(b)(1) conflicted with the ''all costs'' language of Reg. §1.482-7(d)(1).

> Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's length would behave. The language is unequivocal: this arm's length standard is to be

[58] *See Xilinx Inc. v. Commissioner*, 567 F.3d 482, 488 (9th Cir. 2009), *withdrawn*, 105 AFTR 2d 2010-536 (9th Cir. 2010) (hereinafter ''*Xilinx II*'').

[59] *See Xilinx II*, 567 F.3d at 491, *withdrawn*, 105 AFTR 2d 2010-536.

[60] *See id.* at 492–3, *withdrawn*, 105 AFTR 2d 2010-536. Judge Noonan dissented. He agreed with Judge Fisher that Reg. §1.482-1(b)(1) and §1.482-7(d)(1) were irreconcilable. However, he rejected application of the specific-over-general canon of construction in favor of a purposive approach. Judge Noonan argued that the purpose of the regulation, to achieve ''parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions,'' meant that Xilinx should not be required to include stock-based compensation in the pool of shared costs. He further argued that, where regulations are ambiguous, they should be construed against the drafter (i.e., the government). *See id.*, 567 F.3d at 498.

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> applied "in every case." . . . In contrast, §1.482-7(d)(1) specifies that controlled parties in a cost-sharing agreement must share *all* "costs . . . related to the intangible development area," . . . . Each provision's plain language mandates a different result.[61]

Judge Noonan held that the purpose of the regulations, rather than the specific-over-general canon of construction, should resolve the conflict. The regulatory purpose that Judge Noonan identified was as follows: "The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions."[62] Thus, the Court adopted the empirical, behavioral approach to the arm's-length standard as fundamental to the transfer pricing regulations as a whole.

Judge Noonan went on to hold that Reg. §1.482-7(d)(1) would prevent Xilinx from deducting all of its stock-based compensation in this case, which would frustrate the purpose of the statute. "If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer."[63] Judge Noonan noted the history of the U.S.-Ireland Income Tax Treaty as further support for the primacy of the general arm's-length standard.[64]

Judge Fisher in his concurring opinion explained his frustration with the IRS's "theoretical" arguments.[65] In particular, the IRS attempted to reconcile Reg. §1.482-1(b)(1) and §1.482-7(d)(1) by arguing the circumstances of related-party transactions are inherently different from those of unrelated parties, so it is appropriate for the regulations to treat related parties differently. "The Commissioner reads the arm's length standard as focused on what unrelated parties would do *under the same circumstances*, and contends that analyzing comparable transactions is unhelpful where related and unrelated parties always occupy materially different circumstances."[66] In particular, the IRS argued that unrelated parties are not otherwise exposed to movements in their counter-party's stock, whereas related parties are inherently exposed to movements in their affiliates' stock. According to the IRS, this meant that the arm's-length result had to be determined according to a different standard than how uncontrolled parties structure their cost-sharing arrangements.[67] Judge Fisher rejected this IRS argument to harmonize the two regulations, holding that Xilinx's understanding was more reasonable, and that the IRS argument merely highlighted the ambiguity of the regulations. He also stated:

> I am troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them.[68]

Accordingly, the Ninth Circuit held that the overall purpose of the transfer pricing regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions, and the court held that this entailed a review of how uncontrolled taxpayers actually behave. Moreover, the Ninth Circuit held that another provision of the regulations, specifically the cost-sharing regulations, had to recede in a situation where their application would violate the behavioral arm's-length standard. This holding from *Xilinx* would be critical in the *Altera* decision.

Altera Corp. v. Commissioner, 145 T.C. No. 3 (2015)

Background

The Ninth Circuit's *Xilinx* opinion expressly left open the question of whether intervening amendments to the cost-sharing regulations resolved the conflict in the regulations. Unfortunately for the IRS, the new 2003 regulations were more emphatically prescriptive in approach. The 2003 changes added a cross-reference in the general arm's-length standard, which stated that "Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost-sharing arrangement produces results consistent with an arm's length result."[69] The amendments to the cost-sharing regulations provided explicitly that a cost-sharing participant's shared costs include "stock based compensation." They also included detailed rules for identifying and computing the cost of stock-based compensation.[70]

Altera was a Delaware corporation ("Altera U.S.") with a Cayman Islands subsidiary ("Altera Interna-

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[61] *Xilinx Inc. v. Commissioner*, 598 F.3d 1191, 1196 (9th Cir. 2010) (hereinafter "*Xilinx III*").

[62] *Id.*

[63] *Id.*

[64] *Id.* at 1197 ("It is enough that our foreign treaty partners and responsible negotiators at Treasury thought that the arm's length standard should function as the readily understandable international measure.").

[65] *Id.* at 1198 (Fisher, J. concurring).

[66] *Id.* at 1197 (Fisher, J. concurring).

[67] *Xilinx III*, 598 F.3d at 1198 (Fisher, J. concurring).

[68] *Id.*

[69] *See* Reg. §1.482-1(b)(2) (2003).

[70] *See* Reg. §1.482-7(d)(2) (2003).

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tional''). Altera manufactured, marketed, and sold computer components, software, and related technology. From 1997 through 2007, Altera U.S. and Altera International entered into a master technology license and a cost-sharing agreement to cover R&D for future technology. Under the cost-sharing agreement, the affiliates agreed to pool their resources to conduct the R&D. Altera U.S. granted stock-based compensation to certain of its R&D workers, but did not include the stock-based compensation in the pool of shared costs under the cost-sharing agreement.

For the years after the 2003 amended regulations, 2004 through 2007, the IRS proposed to increase Altera International's cost-sharing payments to take into account the stock-based compensation of Altera U.S.

The IRS said that the sole reason for the adjustments was to bring Altera U.S. into compliance with the 2003 cost-sharing regulations. Altera U.S. petitioned the Tax Court, and the parties brought cross-motions for partial summary judgment on the issue of ''whether section 1.482-7(d)(2) . . . is arbitrary and capricious and therefore invalid.''[71]

Tax Court Opinion

The Tax Court, in a reviewed opinion authored by Judge Marvel, held that Treasury's notice and comment procedures in issuing the 2003 regulations failed to comply with the ''reasoned decisionmaking'' required by section 706(2)(A) of the APA. As a result, the court held that the 2003 regulations were invalid.

Transfer pricing discussion. Judge Marvel explained that the *Xilinx* court had already held that:

> (1) in determining the true taxable income of a controlled taxpayer, the arm's-length standard applies in all cases, (2) the arm's-length standard requires an analysis of what unrelated entities would do, (3) the commensurate with income standard was never intended to supplant the arm's length standard, and (4) unrelated parties would not share [stock-based compensation].[72]

Judge Marvel reviewed the history of the Ninth Circuit affirmation of the Tax Court in *Xilinx*, specifically noting Judge Fisher's concurrence rejecting the IRS's argument that related and unrelated parties always occupy materially different circumstances.[73]

When the Tax Court turned to the IRS's justifications for the 2003 regulations, Judge Marvel found the IRS's arguments lacking. First, the IRS argued that it could make allocations without reference to uncontrolled party conduct. Judge Marvel rejected this IRS argument, reasoning that ''the determination under section 482 is intensely factual'' and that ''[i]n *Xilinx* we held that the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances.''[74] Judge Marvel also observed that Treasury ''necessarily decided an empirical question when it concluded that the [2003 regulation] was consistent with the arm's-length standard.''[75]

Second, the IRS argued that Treasury had authority to issue regulations that modified or even abandoned the arm's-length standard. Judge Marvel dismissed this provocative statement by observing that the preamble to the 2003 regulation did not justify the regulations as a departure from the arm's-length standard.[76]

Judge Marvel then turned the discussion to whether Treasury reasonably concluded, as required by §706(2)(A) of the APA and *State Farm*,[77] that the 2003 regulation was consistent with the arm's-length standard. Judge Marvel held that Treasury failed to meet the *State Farm* reasoned decision-making standard because:

(1) The 2003 regulations had no basis in fact because Treasury did not collect evidence of how unrelated parties structured their cost-sharing transactions, and instead relied on Treasury and IRS's unsupported belief that arm's-length parties should share stock-based compensation;

(2) Treasury failed to rationally connect the 2003 regulations to the facts in the administrative record. Instead, Treasury dismissed evidence of uncontrolled behavior submitted by commentators; and

(3) The 2003 regulations were contrary to the evidence in the administrative record.[78]

APA discussion. The ultimate issue presented by the cross-motions for summary judgment in *Altera* was ''whether section 1.482-7(d)(2) . . . issued in 2003 and which requires participants in qualified cost-sharing arrangements . . . to share [stock-based compensation] to achieve an arm's-length result — is arbitrary and capricious and therefore invalid.''[79] The Tax Court in-

[71] *Altera*, 145 T.C. No. 3, 52.

[72] *Id.* at 57–58.

[73] *Id.* at 59.

[74] *Id.* at 67.

[75] *Id.* at 67–68. (''We therefore need not decide whether, under *Brand X*, Treasury would be free to modify or abandon the arm's-length standard because it has not done so here.'').

[76] *Altera*, 145 T.C. No. 3, 68.

[77] *State Farm*, 463 U.S. at 29.

[78] *Altera*, 145 T.C. No. 3 at 69–74.

[79] *Id.* at 52.

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validated the regulation under the APA,[80] holding (1) that the regulation was a "legislative" regulation, (2) that as a legislative regulation, not only was Treasury required to engage in notice and comment rulemaking under §553 of the APA, but Treasury's rulemaking could not be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" under §706(2)(A) of the APA as applied in *State Farm*, and (3) that Treasury's purported notice and comment rulemaking process for the 2003 regulations constituted invalid agency action under *State Farm*.

The 2003 regulations were "legislative" regulations. Altera took the position that the 2003 regulations were subject to review under the APA because they were legislative regulations. The IRS did not contest that the 2003 amendments were legislative regulations. Instead, the IRS argued that whether the regulation was a legislative regulation was moot, because Treasury in fact followed notice and comment rulemaking. The court ruled on whether the regulations were legislative or interpretive, in part because the taxpayer argued that non-legislative regulations would not be binding on the court.[81]

Judge Marvel held that the 2003 regulations were legislative regulations.[82] Relying on *Hemp*[83] and *Am. Mining Cong.*,[84] she explained that whether regulations are legislative or interpretive turns on whether the regulations have the "force of law" and that "[a] rule has the force of law 'only if Congress has delegated legislative power to the agency and if the agency intended to exercise that power in promulgating the rule.' "[85] *American Mining Congress* set forth three circumstances in which a rule has the force of law, as explained in *Hemp*:[86]

(1) in absence of the rule, there would not be an adequate legislative basis for enforcement action;

(2) the agency has explicitly invoked its general legislative authority; or

(3) the rule effectively amends a prior legislative rule.[87]

Note that the Tax Court's ruling relies significantly on administrative law cases dealing with agencies other than the Treasury.[88] Because tax regulations are squarely within the APA, essentially all of the case law dealing with the APA seems potentially relevant, subject to the usual rules concerning binding precedent.

[80] The IRS is like any other agency for purposes of APA. *Mayo* directly presented the issue of whether legislative Treasury regulations were subject to *Chevron* deference or should be examined under a less stringent standard, such as the multi-factor test set forth in *National Muffler*. The Supreme Court decided that Treasury regulations, like the regulations of other agencies, are tested under *Chevron* and *Mead*, and not *National Muffler*.

[81] *Altera*, 145 T.C. No. 3, 66. Presumably, the taxpayer argued that the regulations would be subject to *Skidmore* deference, *Skidmore v. Swift & Co.*, 323 U.S. 134, 139–40 (1944) (the weight to be accorded to an administrative action will depend on its power to persuade, based on the thoroughness evident in its consideration, the validity of its reasoning, and its consistency with earlier and later pronouncements). *Skidmore* deference has been applied, for example, to revenue rulings, because they do not have the force of law. *See In re: Worldcom, Inc.*, 723 F.3d 346, 357–58 (2d Cir. 2013). The Tax Court did not decide whether *Skidmore* deference would apply if the regulation in *Altera* were determined to be an interpretive regulation.

[82] *Altera*, 145 T.C. No. 3, 67.

[83] *Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003). In *Hemp*, the Ninth Circuit addressed the issue of whether a Drug Enforcement Agency (DEA) rule banning all naturally occurring THC — the active ingredient in marijuana, including the trace amounts found in hemp seed and oil — was a legislative rule, requiring notice and comment under the APA, or an interpretative rule. The petitioners in *Hemp*, which sold products including hemp seed and oil, faced potential criminal prosecution under this rule. Previously, the applicable regulations excluded hemp seed and oil from the prohibited products, so Hemp could not have been prosecuted. Although *Hemp* recited and discussed the "no basis for enforcement" basis for finding the rule to be legislative, the Ninth Circuit's holding in *Hemp* was that the new rule was inconsistent with a prior rule permitting sale of products (other than marijuana) with trace amounts of THC, such as hemp seed and oil. Consequently, the court held that the new rule was a legislative rule under the third circumstance listed below.

[84] *Am. Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1983). In *American Mining Congress*, the D.C. Circuit addressed the issue of whether the Mine Safety and Health Administration's program policy letters (PPLs) related to whether x-ray readings were "diagnoses" of lung disease were legislative or interpretive regulations under the APA. The D.C. Circuit found the PPLs to be interpretative, applying the three-part test above. Most notably, the court found that the existing regulations already required reporting diagnoses of lung disease, so there was no legislative gap to fill, and the agency did not invoke its general legislative rulemaking authority in issuing the letters.

[85] *Altera*, 145 T.C. No. 3, 64. Similarly, *Mayo* provides that "[w]e have explained that the 'ultimate question is whether Congress would have intended, and expected, courts to treat [the regulation] as within, or outside, its delegation to the agency of 'gap filing' authority," citing *Long Island Care at Home Ltd. v. Coke*, 551 U.S. 558, 173 (2007).

[86] A fourth factor, whether the regulation was published in the C.F.R., has since been discredited. *See Health Ins. Ass 'n of Am., Inc. v. Shalala*, 23 F.3d 412 (D.C. Cir. 1994) (publication of a rule in the C.F.R. is merely a "snippet" of evidence that a regulation is legislative, resulting in removal of that factor from the *American Mining Congress* list of factors).

[87] *See* 995 F.2d at 1106, 1112 (D.C. Cir. 1993).

[88] In addition to *American Mining Congress* and *Hemp*, the Tax Court's *Altera* opinion also relied on *Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87 (1995), and *Home Box Office Inc. v. FCC*, 567 F.2d 9 (D.C. Cir. 1977), which address regulations issued by the Health and Human Services and the Federal Communications Commission (FCC).

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Applying these APA precedents, Tax Court found the regulation to be a legislative regulation, stating as follows:

> We further conclude that Treasury intended for the final rule to have the force of law for the following reasons: (1) the parties stipulated-and we agree, *see Xilinx v. Commissioner*, 125 T.C. at 37, that the adjustments to petitioner's income can be sustained only on the basis of the final rule, *see Hemp Indus.*, 333 F.3d at 1087, and (2) in promulgating the final rule Treasury invoked its general legislative rulemaking authority under section 7805(a), *see id.* The final rule is therefore a legislative rule. *See Am. Mining Cong.*, 995 F.2d at 1109.[89]

In light of the earlier *Xilinx* case, absent the changed regulation, the taxpayer would prevail. The only way the IRS could prevail would have been because the 2003 regulations, if valid, changed the result in *Xilinx*. This is a classic example of a regulation that has the force of law.[90]

In adopting the regulations, Treasury relied on the general regulatory authority granted under §7805, to ''prescribe all needful rules and regulations for the enforcement of this title.''[91] Judge Marvel also held that regulations adopted under §7805 ''carry the force of law, and the Code imposes penalties for failing to follow them.''[92] Similarly, *Mayo* dealt specifically with the issue of whether regulations adopted under the general grant of authority, §7805, were subject to lower deference than regulations granted under a specific grant of regulatory authority, finding that the degree of deference ''does not turn on whether Congress's delegation of authority was general or specific.''[93] This seems ironic, at least to tax lawyers of a certain age, because historically the adoption of a regulation pursuant to the general rulemaking authority in §7805 was the linchpin of a conclusion that a regulation was an interpretive regulation, at least in tax parlance.[94]

The use of notice of comment rulemaking is also a ''significant'' sign that a rule merits *Chevron* deference.[95] Although notice and comment may be an indicator for many agencies that the agency intended a regulation to be a legislative regulation, this intent may be less clear in the case of Treasury's adoption of tax regulations. *Mayo* recognizes that at least some Treasury regulations are interpretive, or there would be no reason to inquire about whether the regulation was intended to be an exercise of gap-filing authority.[96] According to a study of Treasury regulations by University of Minnesota, Professor Kristen Hickman, Treasury often followed notice and comment procedures (60% of the time), rarely conceded that regulations were subject to the notice and comment requirements of the APA (only 8% of the time), and rarely provided any explanation for why notice and comment would not apply (only 20% of the time).[97] Given the inconsistent signals from Treasury, it is unclear whether a court will, or should, generally attri-

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89 *Altera*, 145 T.C. at 67.

90 That the prior law was determined by a case, *Xilinx*, potentially raised the issue of whether a regulation could be granted *Chevron* deference when it conflicted with a prior case, holding to the contrary. In *Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Serv.*, 545 U.S. 967, 982–83 (2005), the Supreme Court held that an agency interpretation was subject to *Chevron* deference even if conflicting with a prior interpretation by a court. Subsequently, in *United States v. Home Concrete Supply, LLC*, 566 U.S. __, 132 S. Ct. 1836, 1842–43 (2012), the Supreme Court held that the *Brand X* principle did not apply when the prior case held that the statute was unambiguous under *Chevron* Step One. The Tax Court found that the regulation would still be reviewed under *Chevron*, before deciding the regulation was invalid for other reasons. *Altera*, 145 T.C. No. 3 at 68. *Xilinx* was based on a finding of fact, that stock option compensation was not included in cost-sharing arrangements between unrelated parties operating at arm's length, and on a finding that the regulation was unambiguous.

91 T.D. 9088.

92 *Altera*, 145 T.C. No. 3, 67.

93 562 U.S. at 57. *See Intermountain Insurance of Vail LLC v. Commissioner*, 134 T.C. 211, 241–42 (2010) (Halpern and Holmes, JJ., concurring in result).

94 The *Altera* opinion acknowledges that the Tax Court previously referred to regulations issued pursuant to specific grants of regulatory authority as ''legislative regulations,'' and regulations issued under the §7805 general grant of rulemaking authority as ''interpretive regulations.'' ''Because the terms 'legislative' and 'interpretive' have different meanings in the administrative law context, we will refer to regulations issue pursuant to specific grants of rulemaking authority as specific authority regulations and regulations issued pursuant to Treasury's general rulemaking authority, under sec. 7805(a), as general authority regulations.'' *Altera*, 145 T.C. No. 3 at 64, n. 10. In 1965, in his seminal article, *The Four R's, Regulations, Rulings, Reliance and Retroactivity, A View From Within*, Mitchell Rogovin, then IRS Chief Counsel, explained the distinction between legislative and interpretative regulations based on the general vs. specific distinction. Even then, Rogovin noted that legislative regulations were subject to notice and comment under the APA, while interpretative regulations appeared not to be, and that legislative regulations were seen as having the force and effect of law and being entitled to more deference, and interpretative regulations were not. *Id.* at 758–59 and n. 6.

95 *Mayo*, 562 U.S. __, Slip Op. at 12; *Mead*, __ U.S. at 230–31; *Long Island Care*, 551 U.S. at 173–74.

96 *Mayo*, 562 U.S. __, Slip Op. at 12.

97 *See* Kristen Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 Notre Dame L. Rev. 1727, 1748–51.

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bute to Treasury an intent to adopt legislative regulations.[98]

Altera confirms that most Treasury regulations are legislative regulations. Accordingly, Treasury should probably expect a flood of regulatory challenges based on flaws in its rulemaking process. Regardless of which party seeks to avoid legislative characterization, it will face an uphill battle if the regulation at issue was adopted under the authority of §7805 or some more specific grant of regulatory authority, and Treasury followed notice and comment procedures.

Legislative regulations are subject to arbitrary-and-capricious review under State Farm. The Tax Court determined that 2003 amendments to the cost-sharing regulations, as legislative regulations, were subject to the notice and comment requirements of §553 of the APA. Where an agency promulgates regulations under the notice and comment procedures of §553 of the APA, it must (1) publish a general notice of proposed rulemaking in the Federal Register, (2) provide an opportunity for interested persons to submit written comments on the proposed rule, and (3) following consideration of the matter, incorporate in the rules a concise general statement of their basis and purpose.[99]

More significantly, the Tax Court found that it had to determine whether Treasury's actions in promulgating the regulations complied with §706(2)(A) of the APA. The agency's actions in completing these steps must be reasonable; §706(2)(A) of the APA requires reviewing court to "hold unlawful and set aside" agency action found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[100]

The Supreme Court's opinion in *State Farm* articulates the standards for review under APA §706(2)(A). This review is often referred to as a "hard look" at the manner through which the regulation was adopted.[101] *State Farm* includes a combination of procedural and substantive requirements, primarily looking to the manner in which a regulation was promulgated or other agency action was taken. These requirements were articulated and applied in *Altera*. In particular:

- "The reviewing court 'may not supply a reasoned basis for the agency's action that the agency itself has not given.' *State Farm*, 463 U.S. at 43 (quoting *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947))."[102] Essentially, the regulation is reviewed on the basis of what was said by the agency at the time, not *post-hoc* rationalizations.
- "[A] reviewing court must ensure that the agency "engaged in reasoned decisionmaking." *Judulang*, 565 U.S. at __, 132 S. Ct. at 484. To engage in reasoned decisionmaking, "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.' " *State Farm*, 463 U.S. at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962))."[103]

The requirement that the agency provide an explanation includes that an agency "that departs from an agency's prior position . . . must 'display an awareness that it is changing its position.' "[104]

- More substantively, "[n]ormally, an agency rule would be arbitrary and capricious if the agency

[98] The courts routinely disregard whether an agency treated a rule as an interpretive rule in determining whether it is legislative. For example, in *Hemp* the court explained: "While the DEA has characterized its rule as an interpretive rule, the court need not accept the agency characterization at face value. *See Gunderson v. Hood*, 268 F.3d 1149, 1154 n. 27 (9th Cir. 2001)." In *Long Island Care at Home, Ltd. v. Coke*, 376 F.3d 118, 132 (2d Cir. 2004), *rev'd*, 551 U.S. 158 (2007), the Second Circuit dismissed the argument that a rule that was the product of notice and comment rulemaking was a legislative rule, reasoning that both interpretive and legislative rules could be adopted by notice and comment, and citing *Mejia-Ruiz v. INS*, 51 F.3d 357, 365 (1995). Although the Supreme Court found that the rule was legislative, and in so doing noted the rule was adopted using notice and comment rulemaking, the Supreme Court did not reject the reasoning of the Second Circuit, but found that the agency had not in fact adopted interpretive rules using notice and comment and had treated this rule just like all other rules. *See also Health Ins. Ass 'n of Am., Inc. v. Shalala*, 23 F.3d 412 (D.C. Cir. 1994) (rejecting publication of a rule in the C.F.R. as a factor indicative of legislative rulemaking); Richard L. Pierce, Jr., *Distinguishing Legislative Rules from Interpretative Rules*, 52 Admin. L. Rev. 547, 555 (2000).

[99] *Altera*, 145 T.C. No. 3, 63–64. *See* 5 U.S.C. §553(b), §553(c). Although these requirements do not apply to so-called "interpretive rules," i.e., those that merely explain preexisting substantive law, *id.* §553(b)(A), they do apply to "legislative rules," i.e., those that have the "force and effect of law." *See Perez v. Mortg. Bankers Ass'n*, 135 S. Ct. 1199 (2015).

[100] *See* 5 U.S.C. §706(2)(A).

[101] *See, e.g.,* Patrick Garry, *The Values and Viewpoints Affecting Judicial Review of Agency Actions: A Focus on the Hard-Look Doctrine*, 53 Washburn L. J. 71 (2013); Note, *Rationalizing Hard Look Review After the Fact*, 122 Harv. L. Rev. 1909 (2009).

[102] *Altera*, 145 T.C. No. 3 at (24). *Chenery* further provides: "The courts may not accept appellate counsel's *post hoc* rationalizations for agency action. It is well established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself." 332 U.S. at 196. Further, "[t]he reviewing court should not attempt itself to make up for such deficiencies (rationale the agency failed to supply); we may not supply a reasoned basis for the agency's action that the agency has not given." *Id.*

[103] *Altera*, 145 T.C. No. 3 at 64–65. The *State Farm* requirement that Treasury provide an explanation for its rule was one of the bases for the Federal Circuit overturning a uniform capitalization regulation in *Dominion Res., Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012).

[104] *Altera*, 145 T.C. No. 3 at 65 (citing *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 515 (2009)).

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has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.''[105]

- However, ''this 'standard is narrow and a court is not to substitute its judgment for that of the agency.' ''[106] The court must determine whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. ''[T]he reviewing court must 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.' ''[107]

Thus, although *State Farm*'s reasoned decision-making review standard includes cautionary language, the requirement that there be a rational explanation at the time the regulation was adopted arguably extends beyond *Chevron* deference.[108] Patrick Smith has observed that *Chevron* is often cited in tax cases, and *State Farm* is not.[109] Presumably, that will change when taxpayers challenge regulations following *Altera*.

In *Altera*, Judge Marvel held that whether *Chevron* or *State Farm* applies is irrelevant, because Chevron Step 2 effectively incorporates the arbitrary-and-capricious test under *State Farm*. In other words, *State Farm*'s test is a part of *Chevron* Step 2, and a regulation must satisfy both *Chevron* Step 2 and *State Farm* to be valid.[110] Generally, *Chevron* review appears to apply when the issue is whether an agency's exercise of its rulemaking power has contravened the substantive limits of the statute, and *State Farm* looks more to whether the proper procedures were followed in adopting the rules.[111] Regardless of whether these are separate tests or part of the same test, the bottom line is that tax regulations must satisfy the standards of both *Chevron* and *State Farm*.

The regulations failed to meet the State Farm reasoned decision-making standards. Judge Marvel held that Treasury failed to meet the *State Farm* reasoned decision-making standards. Treasury was faced with factual evidence that parties did not share stock-based compensation at arm's length and admitted that its files did not contain any evidence that parties did share stock-based compensation at arm's length. Treasury argued that it was not obligated to engage in such fact finding. The Tax Court rejected that argument, quoting from *Tripoley Rocketry*[112] as follows:

> Where an agency has articulated no reasoned basis for its decision — where its action is founded on unsupported assertions or unstated references — ***[a court] will not abdicate the judicial duty carefully to ''review the record to ascertain that the agency has made a reasoned decision based on reasonable extrapolations from some reliable evidence.[113]

The Tax Court rejected two arguments made by the IRS in support of its position. First, the IRS argued that some propositions require reasoned conclusions because there is scant empirical evidence available. The court, however, held that this was not such a case, given the information supplied by commentators in

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[105] *Id.* (citing *State Farm*, 463 U.S. at 43).

[106] *Id.*

[107] *Id.*

[108] *Chevron* analysis consists of two steps. Under *Chevron* Step 1, a court will determine whether Congress has directly spoken to the question at issue or whether there is a gap. There is no deference under *Chevron* Step 1 because, if the court finds that Congress has directly spoken, then the regulation must follow the unambiguous intent of Congress. If there is a gap, then the court will proceed to *Chevron* Step 2, where the court may exercise deference. Under *Chevron* Step 2, a court will defer to a regulation as an authoritative interpretation of an ambiguous statute unless the regulation is ''arbitrary or capricious in substance, or manifestly contrary to the statute.'' *Mayo*, 562 U.S. at 53; *Altera*, 145 T.C. No. 3 at 42.

[109] Patrick Smith, *Mannella, State Farm, and the Arbitrary and Capricious Standard*, 131 Tax Notes 387 (Apr. 25, 2011).

[110] *See Altera*, 145 T.C. No. 3 at 68, 75 n. 29.

[111] *See Arent v. Shalala*, 70 F.3d 610 (D.C. Cir. 1995) (''The *Chevron* analysis focuses on discerning the boundaries of Congress' delegation of authority to the agency; and as long as the agency stays within that delegation, it is free to make policy choices in interpreting the statute, and such interpretations are entitled to deference.'' Because it was undisputed that the FDA had authority under the Act to define ''substantial compliance,'' the issue before the Court was whether the FDA's discharge of that authority was reasonable. That question falls within the province of traditional arbitrary and capricious review under 5 U.S.C. §706(2)(A) and *State Farm* review.''); *Penick Corp. v. Drug Enforcement Admin.*, 491 F.3d 483 (D.C. Cir. 2007) (''our statutory interpretation is governed by the deferential two-step analysis of *Chevron*''); *Stillwell v. Office of Thrift Supervision*, 569 F.3d 514 (D.C. Cir. 2009) (Stillwell argues that the regulation is arbitrary and capricious under the APA but does not argue that the rule violates any particular statutory provision, therefore, this is a *State Farm* case, not a *Chevron* case); *Recording Indus. Ass'n of Am., Inc. v. Librarian of Cong.*, 608 F.3d 861 (D.C. Cir. 2010) (RIAA does not contend that the Board contravened any specific statutory limit, so this is a *State Farm* case, not a *Chevron* case).

[112] *Tripoley Rocketry Ass'n v. Bureau of Alcohol, Tobacco, Firearms & Explosives*, 437 F.3d 75. 83 (D.C. Cir. 2006).

[113] *Altera*, 145 T.C. No. 3 at 69–70.

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the record and the previous findings in *Xilinx*.[114] Second, the IRS argued that the court should defer to Treasury's expertise, citing the Ninth Circuit's deference to the agency expertise of the Bureau of Prisons in *Peck v. Thomas*,[115] which involved the validity of a Bureau of Prisons regulation governing the standards for early release of prisoners. The Tax Court rejected that argument as well, reasoning that the Bureau of Prisons had ''correctional expertise'' to know which offenses warranted preclusion from an early prison release program in *Peck*, whereas Treasury admitted that it had no knowledge of any transactions in which parties operating at arm's length shared stock-based compensation.[116]

The court also held that the IRS could not claim that Treasury relied on its expertise now, in court, because Treasury had not set forth that contention at the time the regulation was promulgated, in the preamble, as required under *State Farm* and *Chenery*, discussed above.[117] This holding, that the arguments made in court are not relevant if not made at the time, is repeated often in the court's holding.

The court found that the final rule was invalid because it was contrary to the evidence before Treasury. Treasury did not submit any evidence to support its beliefs as to whether unrelated cost-sharing participants share stock option costs, and did not state that any of the evidence contrary to the factual premise for the adopted rule lacked credibility. Thus, although the Tax Court would not ''substitute its judgment for that of the agency'' under *State Farm*, in this case Treasury's explanation for its decision ''runs counter to the evidence before it'' and must be reversed.[118]

The court found that Treasury failed to rationally connect its regulation, requiring all stock-based compensation to be shared in every cost-sharing arrangement, with the facts it found — that Treasury believed that parties entering into cost-sharing arrangements for ''high-profit'' intangibles would share stock-based compensation if it was a ''significant element'' of the compensation. Essentially, the court found that the regulation was overly broad, and rejected the IRS argument that this was for administrative convenience as both unsupported by the record and not stated at the time the rule was promulgated (another reference to the *Chenery* principle).[119]

The IRS argued that the regulation should be upheld under the commensurate-with-income principle in §482. The court held, as discussed above, that the regulation must satisfy the arm's-length principle, under *Xilinx* and under U.S. treaty obligations. The court held that, because Treasury did not rely exclusively on the commensurate-with-income standard, the court could not sustain the rule solely on that basis if the rule fails the arm's-length standard.[120] This is the so-called two-legged stool argument, if a rule is based on two reasons, and one falls away, the rule cannot stand. If the reasons are alternatives, or ''the court is certain that the agency would have taken the same action even absent the flawed rationale,''[121] then it can stand based on one reason. In this case, the court found that, given the incorporation of the arm's-length standard in many tax treaties, the IRS could not reasonably contend that Treasury would have taken the same action if it had concluded stock-based compensation was not shared by parties at arm's length.[122]

Last, the court found that Treasury failed to respond to significant comments. The court reviewed comments relating to arm's-length transactions submitted by a number of commentators, finding basically that Treasury's dismissal of those comments was without basis in the record at the time, or in the record before the court. The Tax Court concluded:

> Although Treasury's failure to respond to an isolated comment or two would probably not be fatal to the final rule, Treasury's failure to meaningfully respond to numerous and significant comments certainly is.[123]

CONCLUSIONS

Altera's ruling that stock-based compensation is not required to be included in the cost pool under a cost-sharing arrangement is itself a significant ruling. Many post-2003 cost-sharing arrangements were drafted to include stock-based compensation contingently, and to exclude stock-based compensation if

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[114] *Id.* at 70.

[115] 697 F.3d 797 (9th Cir. 2012).

[116] *Altera*, 145 T.C. No. 3 at 70.

[117] *Id.* at 71.

[118] *Id.* at 75.

[119] *Id.* at 71–72.

[120] *Id.* at 69.

[121] *Id.* at 65, *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir. 2006). Jasper Cummings, in an interesting article, *Holding Treasury to Its Word: Altera and Capricious Regulations*, 2015 TNT 207–9, criticizes the Tax Court for relying on D.C. Circuit cases, *Nat'l Fuel Gas Supply*, *Allied-Signal, Inc. v. U.S. Nuclear Regulatory Comm'n*, 988 F.2d 146 (D.C. Cir. 1983), and *Consol. Edison Co. of N.Y. v. FERC*, 823 F.2d 630 (D.C. Cir. 1987), when *Altera* is appealable to the Ninth Circuit. Cummings argues the Tax Court's multiple-rationale conclusion is an ''error,'' but does not cite any authority in the Ninth Circuit to the contrary and does not seem to explain why the D.C. Circuit is incorrect. Much of administrative law is developed in the D.C. Circuit, and it seems insufficient to simply dismiss its cases without explanation merely because the *Altera* case would not be appealed to the D.C. Circuit.

[122] *Altera*, 145 T.C. No. 3 at 75.

[123] *Id.* at 73.

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the regulation was declared invalid. If the Ninth Circuit agrees with the Tax Court that the regulation is invalid, the IRS should expect a large number of refund claims.

The legal principles in *Altera* are also significant, and may have longer lasting impact. It is now clear that §482 requires consideration of whether a transaction is conducted at arm's length based on empirical evidence, not just economic theory or abstract arguments. The stock-based compensation regulations had a robust history, including *Xilinx* and the regulatory process, and did not stand because the IRS made the choice to rely on its theoretical approach to determining arm's-length behavior. The IRS did not prove that stock-based compensation was actually shared at arm's length, choosing instead to rely on its own theoretical approach to describing how arm's-length parties "should" behave. That choice failed. Whether the next challenged regulation will have such a clear factual record or such a robust administrative record, is uncertain.

It is also now clear that many Treasury regulations will be subject to review under the "hard look" standards of *State Farm.* Significantly, that review is conducted based on the record as it existed when the regulations were promulgated, not *post-hoc* rationalizations offered by the IRS in litigation. Where Treasury failed to provide an explanation for its regulation, as in *Dominion Resources*, or where the regulation is premised on empirical evidence that the Treasury failed to find, as in *Altera*, regulations will in many cases be held invalid.

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