Nos. 16-70496, 16-70497

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ALTERA CORPORATION AND SUBSIDIARIES,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISIONS OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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GLOSSARY

APA – Administrative Procedure Act, 5 U.S.C. § 551 *et seq*.

Coordinating amendments – Treas. Reg. §§ 1.482-1(b)(2)(i) (2003) (second sentence), 1.482-7(a)(3) (2003)

ER – Excerpts of Record

FASB – Financial Accounting Standards Board

1986 Act – Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085

1986 Conference Report – H.R. Conf. Rep. No. 99-841 (1986)

1986 House Report – H.R. Rep. No. 99-426 (1985)

QCSA – qualified cost-sharing arrangement

R&D – research and development

SBC rule – Treas. Reg. § 1.482-7(d)(2) (2003)

SFAS 123 – Statement of Fin. Accounting Standards No. 123 (1995)

TAMRA – Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342

2002 preamble – preamble accompanying the issuance of the 2003 cost-sharing amendments in proposed form

2003 cost-sharing amendments – amendments to Treas. Reg. §§ 1.482-1 and 1.482-7 issued in final form in August 2003

2003 preamble – preamble accompanying the issuance of the 2003 cost-sharing amendments in final form

White Paper – Notice 88-123, 1988-2 C.B. 458

STATEMENT OF JURISDICTION

Altera Corporation ("Altera") was the common parent of an affiliated group of U.S. corporations (the "Altera consolidated group" or the "group") that filed consolidated federal income tax returns with respect to its taxable years ending in 2004, 2005, 2006, and 2007. (ER104-105.) On December 8, 2011, the Internal Revenue Service (IRS) issued a notice of deficiency to the group that included its 2004 tax year. (ER105.) *See* Internal Revenue Code (26 U.S.C.) ("I.R.C." or the "Code") § 6212(a). On March 6, 2012, within 90 days after the date of that notice, the group timely filed a petition for redetermination in the United States Tax Court (Tax Court docket no. 6253-12). (ER267.) *See* I.R.C. § 6213(a). The Tax Court had jurisdiction under § 6213(a). *See* I.R.C. § 7442.

On January 23, 2012, the IRS issued a notice of deficiency to the Altera consolidated group with respect to its 2005, 2006, and 2007 tax years. (ER105.) On April 20, 2012, within 90 days after the date of that notice, the group timely filed a petition for redetermination in the Tax Court (Tax Court docket no. 9963-12). (ER230.) The Tax Court had jurisdiction under I.R.C. § 6213(a). *See* I.R.C. § 7442.

The Tax Court entered a decision in docket no. 6253-12 on December 1, 2015, and it entered a decision in docket no. 9963-12 on December 28, 2015. (ER1-7.) Those decisions constitute final judgments, disposing of all claims of all parties. *See* I.R.C. § 7459(a). On February 19, 2016, within 90 days after entry of each decision, the Commissioner timely filed notices of appeal with the Tax Court. (ER79-88.) *See* I.R.C. § 7483. This Court has jurisdiction under I.R.C. § 7482(a)(1).

STATEMENT OF THE ISSUE

Whether the Tax Court erred in holding that the 2003 amendments to Treas. Reg. (26 C.F.R.) §§ 1.482-1 and 1.482-7 are invalid to the extent they require commonly controlled parties in a qualified cost-sharing arrangement for the development of intangible property to share stock-based compensation costs.

STATEMENT OF THE CASE

A. Overview

1. I.R.C. § 482

I.R.C. § 482 governs the pricing of transactions (such as the one at issue here) between commonly controlled parties, and reads as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

That grant of authority is broad, and the Treasury Department ("Treasury") has issued hundreds of pages of regulations under § 482 pursuant thereto.

2. The regulations at issue

This case involves a cost-sharing arrangement between Altera and its Cayman Islands subsidiary that did not take into account stock-based compensation costs, contrary to the 2003 amendments to Treas. Reg. §§ 1.482-1 and 1.482-7 (the "2003 cost-sharing amendments").[1]

[1] See the attached Addendum. In 2009, Treasury redesignated § 1.482-7, as in effect from 1995 through 2008, as § 1.482-7A. *See* T.D. 9441, 2009-7 I.R.B. 460, 474. Like the Tax Court, we use the original designation in this brief.

One of those amendments clarified that the existing definition of "costs" that related entities must share under a qualified cost-sharing arrangement (QCSA) – a definition that clearly encompassed compensation expense – includes stock-based compensation costs (*e.g.*, costs associated with compensatory stock options). *See* Treas. Reg. § 1.482-7(d)(2) (2003). Other amendments clarified that the existing rule requiring QCSA participants to share the defined set of costs in proportion to their reasonably anticipated benefits from the arrangement must be satisfied in order for the QCSA to produce an arm's-length result, the attainment of which limits the IRS's authority to reallocate the resulting deductions among the related entities pursuant to I.R.C. § 482. *See* Treas. Reg. §§ 1.482-1(b)(2)(i) (2003) (second sentence), 1.482-7(a)(3) (2003).[2]

3. The Tax Court's disposition of the case

The Tax Court invalidated the 2003 cost-sharing amendments on the ground that, in the preamble accompanying the issuance of the

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[2] The term "arm's length result" is defined in the subjunctive as "the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. § 1.482-1(b)(1) (1994) (second sentence).

amendments in their final form, Treasury failed to provide any empirical basis for its conclusion that requiring stock-based compensation costs to be included in the cost-sharing pool was consistent with the arm's-length standard. In particular, the court held that § 1.482-7(d)(2) failed to satisfy the "reasoned decisionmaking" standard set forth in *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983), and therefore was arbitrary and capricious within the meaning of § 706(2)(A) of the Administrative Procedure Act, 5 U.S.C. § 551 *et seq*. ("APA"). Based on its conclusion that the analysis under *State Farm* and the analysis under "step 2" of the framework set forth in *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), are interchangeable, the court further concluded that § 1.482-7(d)(2) would be invalid under *Chevron* as well.

B. Statutory and regulatory framework

1. I.R.C. § 482 – first sentence

The first sentence of I.R.C. § 482 – the substance of which dates back to 1928, and which was the *only* sentence until 1986 – authorizes the Secretary of the Treasury (or his delegate, *see* I.R.C. § 7701(a)(11)(B)) to allocate certain tax items among commonly controlled entities in order to prevent the evasion of tax or to clearly reflect the income of any such entities. Although § 482 and the regulations thereunder are not limited to cross-border transactions, that is the context in which § 482 issues typically arise. For instance, in the absence of § 482, a U.S. company that derives some of its profits from product sales in Country *X* (a lower-tax jurisdiction) might seek to avoid (or at least defer) U.S. tax on those profits by forming a Country *X* subsidiary, selling the product to that subsidiary at cost, and then causing the subsidiary to resell the product in Country *X* at retail.

2. The 1968 regulations and the concept of cost-sharing arrangements

The first sentence of Treas. Reg. § 1.482-1(b)(1) (1994) – the substance of which dates back to 1935 – provides that "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Early versions of the § 482 regulations did not provide any guidance regarding the practical application of the arm's-length standard, and contemporaneous judicial opinions yielded no discernible pattern. In 1962, in lieu of adopting a House provision that would have addressed "the difficulty in using the present section 482" through an extensive statutory amendment, the Conference Committee with respect to the Revenue Act of 1962 urged Treasury to "explore the possibility of developing and promulgating regulations… which would provide additional guidelines and formulas for the allocation of income and deductions" under § 482. H.R. Rep. No. 87-1447, at 28 (1962); H.R. Conf. Rep. No. 87-2508, at 19 (1962).

The resulting regulations – proposed in 1965 and finalized in 1968 – provided rules specific to several types of transactions, including those involving the transfer or use of intangible property. *See* Treas. Reg. § 1.482-2(d) (1968). The intangibles regulation contained a special rule applicable to "bona fide cost sharing arrangements," defined as "an agreement…between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced." Treas. Reg. § 1.482-2(d)(4) (1968). Under that rule, the IRS would "not make allocations with respect to such [an arrangement] except as may be appropriate to reflect each participant's arm's length share of the cost and risks of developing the property." *Id.* The rule further provided:

> In order for the 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 which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. [*Id.*]

3. The 1986 amendment of § 482 and its immediate aftermath

As part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (the "1986 Act"), Congress added a second sentence – known as the commensurate-with-income requirement – to § 482: "In the case of any transfer (or license) of intangible property [as defined elsewhere in the Code], the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." The House Report accompanying the legislation makes clear that the impetus for that amendment was a concern regarding the lack of reliably comparable transactions between unrelated parties from which to extrapolate a price under the regulatory arm's-length standard. *See* H.R. Rep. No. 99-426, at 423-426 (1985) (the "1986 House Report").

The corresponding Conference Report specifically refers to cost-sharing arrangements as "an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each." H.R. Conf. Rep. No. 99-841, at II-638 (1986) (the "1986 Conference Report"). That report further provides that participants in such cost-sharing arrangements would be expected to share "all research and development costs" in proportion to their shares of expected profits from the intangible property. *Id.* Finally, the report expresses "[t]he conferees['] belie[f] that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect." *Id.*

Treasury and the IRS issued the requested transfer-pricing study – over 100 single-spaced pages, not counting appendices[3] – in October 1988. *See* Notice 88-123, 1988-2 C.B. 458 (the "White Paper"). "At the conceptual heart of the White Paper was an extended discussion of economic arguments, to which the 1986 Act's legislative history had alluded," regarding the dominance of the integrated business operation

[3] Kathleen Matthews, *Section 482 White Paper Hits the Street*, 41 Tax Notes 362 (Oct. 24, 1988).

in the emerging global economy,[4] the resulting decrease in nonintegrated businesses "that might serve as the source of comparables within the relevant industry," and the implications for "the traditional conception of the arm's length standard." Michael C. Durst & Robert E. Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 Tax L. Rev. 37, 66, 68 (Fall 2003); *see* Notice 88-123, 1988-2 C.B. at 482, 484, 485 (referring to the "traditional arm's length approach" and an "alternative application of the arm's length approach" that "does not directly rely upon comparable transactions"). Treasury reiterated, however, that it "continue[d] to adhere to th[e] view" that, in enacting the commensurate-with-income requirement, "Congress intended no departure from the arm's length standard" itself, which is "embodied in all U.S. tax treaties." 1988-2 C.B. at 475.[5]

[4] "Loosely defined, an integrated business consists of firms under common control and engaged in similar activities." Notice 88-123, 1988-2 C.B. 458, 483.

[5] In a separate discussion of cost-sharing arrangements, the report referred to the "cost share/benefit principle" of the 1986 Conference Report, *viz.*, "the fundamental principle that the costs borne by each of the participants should be proportionate to the reasonably anticipated
(continued…)

At about the same time that Treasury and the IRS issued the White Paper, Congress enacted the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 ("TAMRA"). As part of that legislation, Congress identified several provisions of the 1986 Act with respect to which "a harmonious reading of the [provision] and U.S. tax treaties is not possible." H.R. Rep. No. 100-795, at 303 (1988); S. Rep. No. 100-445, at 320 (1988); *see* TAMRA § 1012(a)(a)(2), (3), 102 Stat. at 3531 (providing in most instances that the treaty obligation would prevail to the extent it was inconsistent with the 1986 Act provision). The commensurate-with-income requirement was not among the listed provisions. Moreover, in their respective committee reports, the House Ways and Means and Senate Finance Committees listed several specific instances in which "the committee does not believe that any [such] conflict exists." H.R. Rep. No. 100-795, at 303; S. Rep. No. 100-445, at 320. Among the provisions that each committee

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(…continued)
benefits to be received over time by each participant from exploiting intangibles developed under the cost sharing arrangement." 1988-2 C.B. at 495. The report also posited that "the costs to be shared should include all direct and indirect costs of the research and development undertaken as part of the arrangement." *Id.* at 497.

"believe[d] [to be] fully consistent with U.S. treaty obligations" were "the provisions requiring that payments with respect to intangibles be commensurate with the income attributable to the intangible ([1986] Act sec. 1231)." H.R. Rep. No. 100-795, at 304; S. Rep. No. 100-445, at 320.

4. The 1994 and 1995 regulations

The White Paper foreshadowed a major overhaul of the § 482 regulations, which culminated in the issuance of final regulations in 1994 (§§ 1.482-1 through 1.482-6, 1.482-8) and 1995 (§ 1.482-7). *See* T.D. 8552, 1994-2 C.B. 93; T.D. 8632, 1996-1 C.B. 85. In addition to incorporating and refining many of the concepts introduced in the White Paper, the 1994 regulations added the following language regarding "the standard to be applied in every case":

> A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482-1(c).

Treas. Reg. § 1.482-1(b)(1) (1994) (internal cross-reference omitted); *see* Treas. Reg. §§ 1.482-1(b)(2)(i) (1994) (providing that "[s]ections 1.482-2 through 1.482-6 provide specific methods to be used to evaluate whether [controlled] transactions…satisfy the arm's length standard"), 1.482-1(c)(1) (1994) (providing that the arm's-length result must be determined under the method that provides the most reliable measure of an arm's-length result).

Consistent with the White Paper, the 1995 cost-sharing regulation (§ 1.482-7) incorporated the "cost share/benefit principle" from the 1986 Conference Report by providing that the IRS would "not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development…equal to its share of reasonably anticipated benefits attributable to such development." Treas. Reg. § 1.482-7(a)(2) (1995). "[P]aragraph (d)," in turn, provided that "a controlled participant's costs of developing intangibles for a taxable year mean[s] all of the costs incurred by that participant related to the intangible development area," as determined by reference to the definition of "operating expenses" contained in § 1.482-5(d)(3) (other than depreciation or amortization expense). Treas. Reg. § 1.482-7(d)(1) (1995). The term "operating expenses" was defined as "all expenses not included in cost of goods sold except for interest expense, foreign…[and] domestic income taxes, and any other expenses not related to the operation of the relevant business activity." Treas. Reg. § 1.482-5(d)(3) (1994).

5. Stock-based compensation

Not long after the December 1995 issuance of § 1.482-7, the IRS made clear that, like any other cost related to the intangible development activity covered by a QCSA, costs associated with compensatory stock options issued to employees engaged in the activity must be included in the pool of costs to be shared. *See, e.g.*, IRS Field Service Advisory, 1997 WL 33107193 (Feb. 21, 1997). Although federal tax law had long treated the amount by which the value of the underlying shares on the exercise date exceeded the option exercise price – known as the "spread" – as a deductible compensation expense (and income to the person exercising the stock option), *see* I.R.C. § 83(h) and Treas. Reg. § 1.83-7(a) (1978) (third and fourth sentences), companies historically had not been required to recognize any expense associated with such options for *financial* reporting purposes if the option exercise price equaled the value of the underlying shares on the option *grant* date (*i.e.*, if the options were issued "at the money"). *See Accounting for Stock Issued to Employees*, Accounting Principles Board Opinion No. 25 (Am. Inst. of Certified Pub. Accountants 1972). In October 1995, however, the Financial Accounting Standards Board announced its conclusion that companies issuing compensatory stock options – including options issued "at the money" – should recognize an expense for financial accounting purposes equal to the "fair value" of the options on the grant date.[6]

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[6] *Accounting for Stock-Based Compensation*, Statement of Financial Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995) ("SFAS 123"). SFAS 123 initially allowed companies to continue using the old "intrinsic value" method of accounting for compensatory stock options in their financial statements, provided they made pro forma disclosures of net income and earnings per share based on the "fair value" method espoused by SFAS 123. *See* SFAS 123, para. 11. The fair value method of SFAS 123 became mandatory in 2005. *See Share-Based Payment*, Statement of Financial Accounting Standards No. 123 (revised 2004) (Fin. Accounting Standards Bd. 2004).

a. The *Xilinx* litigation

The IRS's position regarding stock-based compensation costs under the 1995 cost-sharing regulation was litigated in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). In addition to arguing that stock-based compensation costs are not "costs" for purposes of § 1.482-7, the taxpayer in *Xilinx* argued that unrelated parties entering into a cost-sharing arrangement at arm's length would not include such amounts in the cost-sharing pool. Regarding this latter point, the Commissioner argued that "'application of the express terms of Treas. 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 costs. 125 T.C. at 54 (alteration in original).[7]

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[7] In July 2002, during the pre-trial phase of the *Xilinx* case, Treasury issued (in proposed form) the 2003 cost-sharing amendments at issue here. *Compensatory Stock Options Under Section 482*, 67 Fed. Reg. 48,997 (July 29, 2002). Because those amendments (once finalized) had prospective application only, they did not apply to the tax years at issue in *Xilinx*. *See* pp. 20-22, *infra*.

The Tax Court rejected the IRS's argument in *Xilinx* that the "all costs" requirement of the 1995 cost-sharing regulation encompassed stock-based compensation costs. After noting the "absence of [evidence of]…transactions in which unrelated parties agree to share" such costs, the court turned to the "effect [of that] fact[ ]…on [the IRS's] authority to make allocations pursuant to section 1.482-1." 125 T.C. at 54. The IRS had argued (1) that the enactment of the commensurate-with-income requirement in 1986, together with the legislative history of that amendment, "establish[ ] that, for purposes of determining the arm's-length result in [the context of] cost-sharing arrangements, Congress intended to supplant the use of comparable transactions with internal measures of cost and profit," *id.* at 55-56, and (2) that the foregoing conclusion was entirely consistent with § 1.482-1(b)(1), the 1994 amendment of which provided that the arm's-length result is *generally* determined by reference to comparable uncontrolled transactions. *See id.* at 55.

The Tax Court rejected the IRS's interpretation of the word "generally" in § 1.482-1(b)(1), concluding that the regulation "simply states that 'comparable transactions' are the broad exception available when there are no identical transactions." 125 T.C. at 55. The court further concluded that legislative and regulatory history supported its "holding that *the arm's-length standard* is applicable" to § 1.482-7. *Id.* at 56 (emphasis added).[8] Based on "uncontradicted evidence" presented by Xilinx, *id.* at 59, 61, the court then found that unrelated parties would not share stock-based compensation costs. *See id.* at 58-62. Accordingly, the court concluded that the IRS's interpretation of the "all costs" requirement of § 1.482-7(d)(1) as encompassing stock-based compensation costs was "inconsistent with section 1.482-1." *Id.* at 62.

On appeal, a divided panel of this Court initially reversed the Tax Court, holding that the "all costs" language of § 1.482-7(d)(1) was just as unambiguous as the "in every case" language of § 1.482-1(b)(1), and that § 1.482-7(d)(1), "as the more specific of the two provisions, controls." *Xilinx Inc. v. Commissioner*, 567 F.3d 482, 488, 496 (9th Cir. 2009),

[8] The IRS never argued that the arm's-length standard, which "applie[s] in every case," Treas. Reg. § 1.482-1(b)(1) (1994), did not apply to § 1.482-7. Rather, the IRS argued that, consistent with legislative intent, compliance with the arm's-length standard in the context of a QCSA entails the sharing of all development-related costs – including stock-based compensation costs – in proportion to reasonably anticipated benefits.

withdrawn, 592 F.3d 1017 (9th Cir. 2010).[9] On rehearing, the panel issued a superseding opinion, this time affirming – again by a 2-1 vote – the Tax Court's decision. *See Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010). In that opinion, the Court "conclude[d] that when related to each other, [§§ 1.482-1(b)(1) and 1.482-7(d)(1)] establish an ambiguous standard for determining which costs must be shared," and that the ambiguity should be resolved in favor of § 1.482-1(b)(1) "based on the dominant purpose of the regulations" – which the Court identified as "parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions" – and on treaty considerations. *Id.* at 1196-1197. In a concurring opinion, Judge Fisher (who had authored the withdrawn opinion) agreed that the regulations were ambiguous, concluding that the ambiguity should be resolved in favor of "what appears to have been the understanding of corporate taxpayers in similar circumstances," who "ha[d] not been given clear,

[9] The Court also held in that initial opinion that § 1.482-7(d)(1) did not violate the tax treaty between the United States and Ireland (the domicile of Xilinx's foreign affiliate), and that the stock-based compensation costs at issue were "costs" that were "related to" the intangible development activity within the meaning of the regulation.

fair notice of how the regulations w[ould] affect them." *Id.* at 1198 (Fisher, J. concurring).

In a dissenting opinion, Judge Reinhardt noted that "[t]he stated purpose of the regulatory scheme is 'to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.'" 598 F.3d at 1199 (Reinhardt, J., dissenting) (quoting Treas. Reg. § 1.482-1(a)(1) (1994)). Thus, "the 'all costs' regulation may simply reflect the conclusion that, whatever uncontrolled parties might do, requiring controlled parties to share such costs 'ensure[s] that taxpayers clearly reflect [the] income attributable to [the] controlled transaction[ ]' as a whole." *Id.* (alterations in original). In Judge Reinhardt's view, "[t]he Commissioner['s]…determin[ation]" in that regard "does not appear to be unreasonable." *Id.*

b. The 2003 cost-sharing amendments

As indicated in note 7, *supra*, in July 2002, during the pre-trial phase of the *Xilinx* case (and in response to that litigation and similar disputes with other taxpayers), Treasury issued (in proposed form) the 2003 cost-sharing amendments at issue here. *Compensatory Stock*

Options Under Section 482, 67 Fed. Reg. 48,997 (July 29, 2002). The centerpiece of those amendments was new § 1.482-7(d)(2), which, in addition to specifying that intangible development costs include stock-based compensation costs, provided rules for identifying and measuring such costs. *See id*. at 49,002-49,003. Other amendments "clarif[ied] the coordination of the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1." *Id*. at 48,998. One such amendment added the following sentence to § 1.482-1(b)(2)(i) ("Arm's length methods"): "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." *Id*. at 49,001. Another added § 1.482-7(a)(3), providing that "[a] qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482-1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development…equals its share of reasonably anticipated benefits attributable to such development." *Id*. at 49,002.

After receiving written comments and holding a public hearing, Treasury issued the proposed amendments in final form in August

2003. *See* T.D. 9088, 2003-2 C.B. 841. Although the final amendments included minor changes to certain administrative rules in response to comments, the substance of the rules remained unchanged. In rejecting "comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances," Treasury and the IRS reasoned that (1) compliance with the statutory commensurate-with-income requirement achieves "an arm's length result consistent with legislative intent," (2) the 1986 Conference Report clearly contemplates that a cost-sharing arrangement will satisfy the commensurate-with-income requirement if costs are shared in proportion to reasonably anticipated benefits, and (3) there is no basis (*i.e.*, from an economic standpoint) "for distinguishing between stock-based compensation and other forms of compensation in this context." 2003-2 C.B. at 842.

C. Factual background of the instant case

During the years at issue (2004-2007), Altera was the publicly traded parent company of a multinational enterprise that developed, manufactured, marketed, and sold programmable logic devices and related hardware, software, and pre-defined design building blocks for use in programming those devices.[10] (ER106.) One of its subsidiaries during that period was Altera International, Inc., a Cayman Islands corporation ("Altera-Cayman"). (ER12.)

Altera-Cayman was incorporated on January 22, 1997. (ER129.) Effective May 23, 1997, Altera and Altera-Cayman entered into a Technology Research and Development Cost Sharing Agreement. (ER107.) Pursuant to that agreement, Altera and Altera-Cayman agreed to share research and development (R&D) costs in proportion to the companies' respective anticipated benefits from any resulting new technology, based on a division of beneficial ownership that would permit Altera to exploit the technology in the United States and Canada while permitting Altera-Cayman to exploit the technology in the rest of the world. (ER108-109.)

[10] Altera was acquired by Intel Corporation in December 2015. *See* https://newsroom.intel.com/news-releases/intel-completes-acquisition-of-altera/ (last visited June 13, 2016).

In December 1999, Altera entered into an Advance Pricing Agreement with the IRS covering Altera's 1997-2003 tax years. (ER139.) Under the terms of that agreement, Altera agreed to (and did) include its R&D-related stock-based compensation costs in the pool of costs to be shared with Altera-Cayman each year pursuant to their cost-sharing agreement. (ER139.)

Effective December 27, 2003 (the first day of Altera's 2004 tax year), Altera and Altera-Cayman amended their cost-sharing agreement to reflect the 2003 cost-sharing amendments. (ER183-185.) Among other things, the amendment revised the definition of "R&D Costs" to include stock-based compensation as defined in Treas. Reg. § 1.482-7(d)(2) (2003), subject to Altera's "right to challenge the [regulation's] validity." (ER184.)

Altera and Altera-Cayman amended their cost-sharing agreement again after the Tax Court issued its opinion in *Xilinx* (*i.e.*, regarding the 1995 cost-sharing regulation) in August 2005. (ER186-189.) The amendment expresses "[t]he Parties['] belie[f] that it is more likely than not" that, in light of that opinion, the "inclusion of Stock-Based Compensation in R&D Costs pursuant to [the December 2003 amendment to their agreement] would be contrary to the arm's length standard." (ER186.) Accordingly, the parties agreed that, unless and until a court decision upholding the validity of Treas. Reg. § 1.482-7(d)(2) (2003) became final, they would "suspend the payment of any portion of [a] Cost Share…to the extent such payment relates to" stock-based compensation costs. (ER188.)

D. The present dispute

1. Tax reporting and notices of deficiency

On its 2004-2007 federal income tax returns, the Altera consolidated group (*i.e.*, Altera and its U.S. subsidiaries) accounted for Altera's cost-sharing arrangement with Altera-Cayman in accordance with the 2005 amendment to the underlying agreement, *i.e.*, by reporting cost-sharing payments from Altera-Cayman that were based on a cost-sharing pool that did *not* include Altera's R&D-related stock-based compensation costs. (ER130-144.) The group filed Form 8275-R (Regulation Disclosure Statement) with each of those returns, acknowledging that its position was contrary to Treas. Reg. § 1.482-7(d)(2) (2003) and setting forth the resulting decrease in Altera-Cayman's cost-sharing payment to Altera for that year. (ER130-144.)

In two notices of deficiency covering the Altera consolidated group's 2004-2007 tax years, the IRS increased the group's income by the following amounts to reflect the increased cost-sharing payments from Altera-Cayman to Altera that would result from compliance with § 1.482-7(d)(2):

2004	$24,549,315
2005	$23,015,453
2006	$17,365,388
2007	$15,463,565

(ER15.) The group filed timely petitions in the Tax Court with respect to each of the notices of deficiency. (ER230-300.)

2. Disposition by the Tax Court

On cross-motions for partial summary judgment, the Tax Court, in a reviewed opinion, held that § 1.482-7(d)(2) – which it referred to as the "final rule" – failed to satisfy the "reasoned decisionmaking" standard of *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983), and therefore was invalid under the Administrative Procedure Act. (ER10-11.) The court began by noting that, "[p]ursuant to APA sec. 706(2)(A), a court must 'hold unlawful and set aside agency action, findings, and conclusions' that the court finds to be 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law'." (ER44.) It then observed that, in applying that standard, "a reviewing court must ensure that the agency 'engaged in reasoned decisionmaking.'" (ER44.) "To engage in reasoned decisionmaking," the court continued, "'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.'" (ER44 [quoting *State Farm*, 463 U.S. at 43; additional internal quotation marks omitted].)

Before undertaking its *State Farm* analysis, the court noted the IRS's contention that, "because the interpretation and implementation of section 482 do not require empirical analysis," the validity of the final rule should be reviewed under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), rather than under *State Farm*. (ER51.) In response, the court characterized its opinion in *Xilinx* as holding that "the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances." (ER52-53.) "Similarly," the court continued, "in promulgating the final rule Treasury explicitly considered whether unrelated parties would share stock-based compensation costs in the context of a QCSA." (ER53.)

Treasury therefore "necessarily decided an empirical question when it concluded that the final rule was consistent with the arm's-length standard." (ER53.)

The court then opined that "whether State Farm or Chevron supplies the standard of review is immaterial because Chevron step 2 incorporates the reasoned decisionmaking standard of State Farm." (ER55-56 [fn. ref. omitted].) According to the court, "[b]ecause the validity of the final rule turns on whether Treasury reasonably concluded that it is consistent with the arm's-length standard, the final rule must – in any event – satisfy State Farm's reasoned decisionmaking standard." (ER56.) The court therefore declined to decide "whether Chevron or State Farm provides the ultimate standard of review." (ER56.)

Having concluded (ER54) that Treasury's determination that the final rule "is consistent with the arm's-length standard…is necessarily …empirical," and in light of Treasury's belief when it issued the rule that its determination was not one requiring "fact finding" or "evidence gathering" (ER60), the court found that Treasury's determination "lack[ed] a basis in fact," that "Treasury failed to rationally connect" its determination "with the facts it found," that Treasury did not adequately "respond to…comments" "'resting on solid data,'" and that the determination was "contrary to the evidence before Treasury." (ER56, 78.) The court also rejected the IRS's argument that, "pursuant to the harmless error rule of APA sec. 706, any deficiencies in Treasury's reasoning should not invalidate the final rule." (ER74.) Based on the foregoing, the court held that the final rule "fail[ed] to satisfy State Farm's reasoned decisionmaking standard and therefore is invalid." (ER77.) The court added that, as a result of that holding, the regulation "would be invalid even if we were to conclude that Chevron supplies the ultimate standard of review." (ER77 n.29.)

The Commissioner now appeals.

SUMMARY OF ARGUMENT

The Tax Court erred in invalidating the 2003 cost-sharing amendments. In rendering its decision, the court erroneously relied on its prior opinion in *Xilinx* for the proposition that the arm's-length standard, as articulated in Treas. Reg. § 1.482-1(b)(1) (1994), always requires an analysis of what unrelated parties do under comparable circumstances. That fundamental error, in turn, led to the court's erroneous conclusion (ER53) that "Treasury necessarily decided an empirical question when it" determined that requiring related parties in a qualified cost-sharing arrangement (QCSA) to share stock-based compensation costs is consistent with the arm's-length standard.

1. The 2003 cost-sharing amendments, in addition to clarifying that stock-based compensation expense is a cost, make clear that comparability analysis plays no role in determining the costs that must be shared under a QCSA in order to achieve an arm's-length result. In light of these "coordinating" amendments, the Tax Court's interpretation of § 1.482-1(b)(1) in *Xilinx* is no longer viable. The Tax Court failed to appreciate that those coordinating amendments changed the legal landscape, and the court thus erroneously regarded the regulatory scheme at issue here to be substantially the same scheme that was at issue in *Xilinx*. Similarly, the coordinating amendments serve to supersede this Court's general understanding of the arm's-length standard as reflected in its opinion affirming the Tax Court's *Xilinx* decision. Because Treasury did not decide an empirical question when it determined that requiring the sharing of stock-based compensation costs is consistent with the arm's-length standard, the

Tax Court erred in evaluating the reasonableness of Treasury's decisionmaking on the basis of the "empirical data" aspect of the Supreme Court's opinion in *State Farm*.

2. The coordinating amendments – which provide that related parties in a QCSA must share all R&D-related costs in a prescribed ratio in order to achieve an arm's-length result – are substantively valid under *Chevron* because they are based on a permissible construction of § 482. Under the commensurate-with-income requirement added to § 482 in 1986, adherence to the arm's-length principle implicit in the first sentence of § 482 entails a comparison of the two sides of the related-party transaction under scrutiny. The 1986 House Report makes clear that Congress enacted that purely internal benchmark because it determined that transactions between unrelated parties involving intangible property do not provide a sufficiently reliable basis of comparability to related-party transactions to be exclusively determinative of the arm's-length result.

The 1986 Conference Report goes even further in the context of cost-sharing arrangements, setting forth the basic economic terms that a cost-sharing arrangement must contain in order to satisfy the commensurate-with-income requirement – and, by necessary implication, the arm's-length standard – with no suggestion that related parties could deviate from those terms based on evidence of purportedly comparable arrangements involving unrelated parties. The coordinating amendments incorporate those same basic terms and, by tying them to the arm's-length result, make clear what is implicit in the 1986 Conference Report: the arm's-length result in this context is not determined by reference to cost-sharing arrangements between unrelated parties. The coordinating amendments therefore reflect not only a permissible construction of § 482, but a construction directly supported by the relevant legislative history.

3. The coordinating amendments, moreover, are procedurally valid under the APA because they are the product of reasoned decisionmaking. The preambles accompanying their issuance emphasized that, in requiring the sharing of all R&D-related costs as a condition to achieving an arm's-length result for a QCSA, Treasury was implementing congressional intent as reflected in the legislative history of the 1986 amendment to § 482. An agency's determination and implementation of legislative intent is the epitome of reasoned

decisionmaking, and as long as the agency provides a basic foundation for its conclusions in that regard, as Treasury clearly did here, its actions cannot be arbitrary or capricious.

The decisions of the Tax Court are erroneous and should be reversed.

ARGUMENT

The Tax Court erred as a matter of law in holding that the 2003 cost-sharing amendments are invalid to the extent they require the sharing of stock-based compensation costs

Standard of review

The validity of a regulation presents a question of law that is subject to *de novo* review. *See, e.g., Nat'l Med. Enters., Inc. v. Sullivan*, 957 F.2d 664, 667 (9th Cir. 1992).

A. Introduction

The Tax Court's analysis reflects a fundamental misunderstanding of the arm's-length standard as formulated by the agency that issued the regulations being challenged here. Based largely on its prior decision in *Xilinx*, involving tax years not governed by those regulations, the Tax Court started from the premise that "the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances." (ER52-53.) This was manifest error.

Treasury amended its regulations for later tax years not involved in *Xilinx* – a course of action the Tax Court acknowledged (in *Xilinx*) that Treasury was free to take, *see* 125 T.C. at 58 – to make clear that, in the context of a QCSA, the arm's-length standard does *not* require consideration of actual transactions between unrelated parties. As we will show, those amendments, which were issued pursuant to the very broad grant of authority in § 482 and follow the blueprint of the 1986 Conference Report regarding the acceptable terms of a cost-sharing arrangement, are valid. Therefore, contrary to the premise underlying the Tax Court's *State Farm* analysis, Treasury did *not* "decide[ ] an empirical question" (ER53) when it determined that requiring the sharing of stock-based compensation costs was consistent with the arm's-length standard. Rather, that determination followed from the agency's studied conclusion regarding how Congress, in enacting the commensurate-with-income requirement in 1986, intended the arm's-length standard to operate in the context of intangibles transactions in general, and cost-sharing arrangements in particular. The Tax Court's transmogrification of this legal determination into an empirical determination is wrong and requires reversal by this Court.

B. Framework of analysis

1. The two aspects of the dispute: stock-based compensation as a "cost," and the nature of the arm's-length standard

The 2003 cost-sharing amendments made two separate but interrelated changes to the regulatory scheme. First, they "clarif[ied] that stock-based compensation is taken into account in determining the operating expenses treated as a controlled participant's intangible development costs for purposes of the cost sharing provisions." 67 Fed. Reg. at 48,998; *see* Treas. Reg. § 1.482-7(d)(2) (2003) (the "SBC rule"). Second, they "clarif[ied] the coordination of the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1." 67 Fed. Reg. at 48,998; *see* Treas. Reg. §§ 1.482-1(b)(2)(i) (2003) (second sentence), 1.482-7(a)(3) (2003) (the "coordinating amendments").[11] The amendment to § 1.482-1(b)(2)(i) stated that § 1.482-7 "provides the specific method to be used to evaluate whether a [QCSA] produces

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[11] Treasury also amended the "best method" rule of § 1.482-1(c)(1) to include a cross-reference to § 1.482-7 "for the applicable method in the case of a [QCSA]." Treas. Reg. § 1.482-1(c)(1) (2003).

results consistent with an arm's length result," and new § 1.482-7(a)(3) provided that a QCSA produces an arm's length result "if, and only if," the arrangement incorporates what Treasury had referred to in the White Paper as the cost-share/benefit principle of the 1986 Conference Report, *viz*., that the participants must share all of the costs of intangible development in proportion to their shares of reasonably anticipated benefits attributable to such development. 67 Fed. Reg. at 48,998; *see* Notice 88-123, 1988-2 C.B. at 495.

Significantly, the cost-share/benefit principle itself does not appear to be controversial. For example, a report recommending changes to the § 482 regulations in the wake of the 1986 legislation, submitted to Treasury in July 1987 by 24 multi-national companies – including the current parent corporation of Altera – contained the following statement:

> With respect to determining what costs should be shared, the regulations should follow the Conference Report and require that each cost sharer bear its portion of ALL research and development costs, on successful as well as unsuccessful products within an appropriate product area, and with respect to all relevant development stages. …

Twenty-Four Major Companies Recommend Changes To Clarify Taxation of Intangibles as Part of Section 482 Study, 87 Tax Notes

Today 149-33, at LEXIS .pdf p.25 (Aug. 3, 1987) (emphasis in original); *see also id.* at LEXIS .pdf p.7 (noting that the purpose of the commensurate-with-income requirement "is to ensure, as stated in the Conference Report, that the division of income between related parties 'reasonably reflect the relative economic activity' of the parties," and observing that "this broader purpose…is wholly consistent with the arm's length standard"). This suggests that the ongoing transfer-pricing dispute regarding stock-based compensation costs – a dispute involving multiple versions of regulations issued before companies were required to recognize the value of compensatory stock options issued "at the money" as an expense on their financial statements – is rooted in historical corporate resistance to the notion that such amounts are "costs" in the first place.[12]

Similarly, in objecting to § 1.482-7(a)(3) "only insofar as it incorporates by reference § 1.482-7(d)(2)" (ER102 n.3), Altera

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[12] *See* SFAS 123 (*supra* note 6), para. 60 (noting that "[t]he debate on accounting for stock-based compensation…became so divisive that it threatened the [Financial Accounting Standards] Board's future working relationship with some of its constituents," and that "the nature of the debate threatened the future of accounting standards[-] setting in the private sector").

essentially invited the Tax Court to consider whether, as a general proposition, Treasury can require related parties in a QCSA to share all costs in a prescribed ratio as a condition to achieving an arm's-length result (*i.e.*, whether the coordinating amendments would be valid if Treasury had issued them without issuing the SBC rule). As demonstrated below (and as explained in the preambles to both the proposed and final amendments), that general authority derives from the 1986 amendment to § 482 and the 1986 Conference Report, neither of which suggests that the commensurate-with-income requirement or the cost-share/benefit principle, respectively, is informed by evidence of actual transactions between unrelated parties. And once the validity of the coordinating amendments is established, it follows that the validity of the SBC rule does not turn on an empirical analysis of whether unrelated parties in analogous situations have shared stock-based compensation costs; rather, it simply turns on whether Treasury reasonably determined that R&D-related stock-based compensation costs are "costs" for purposes of § 1.482-7.

2. *State Farm* and *Chevron*

In *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983), the Supreme Court held that an order of the National Highway Traffic Safety Administration (NHTSA) was "arbitrary and capricious" within the meaning of APA § 706(2)(A) and, therefore, unlawful. As part of the National Traffic and Motor Vehicle Safety Act of 1966, Congress had directed the Secretary of Transportation to issue motor vehicle safety standards and, in issuing those standards, to "consider relevant available motor vehicle safety data, including the results of research, development, testing and evaluation activities conducted pursuant to" the Act. 15 U.S.C. § 1392(a), (f)(1) (1976). The NHTSA order at issue rescinded a prior rule requiring automobile manufacturers to begin phasing in the installation of passive restraint systems (either airbags or "automatic" seatbelts) in their cars.

Before undertaking its review, the Court discussed the applicable standard of review at length:

> The scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency. Nevertheless, 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." In reviewing

> that explanation, we must "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." Normally, an agency rule would be arbitrary and capricious if the agency 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. The reviewing court should not attempt itself to make up for such deficiencies: "We may not supply a reasoned basis for the agency's action that the agency itself has not given." We will, however, "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." …

463 U.S. at 43 (citations omitted).[13] The Tax Court referred to these principles, as explicated in subsequent cases, as the "reasoned decisionmaking" standard. (ER51.) *See* 463 U.S. at 52 (holding that NHTSA's "explanation for rescission of the passive restraint requirement is *not* sufficient to enable us to conclude that the rescission was the product of reasoned decisionmaking") (emphasis in original); *see also Encino Motorcars, LLC v. Navarro*, 2016 WL 3369424, at *7 (U.S.

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[13] The Court added that, "[f]or purposes of these cases, it is also relevant that Congress required a record of the rulemaking proceedings to be compiled and submitted to a reviewing court, 15 U.S.C. § 1394, and intended that agency findings under the Act would be supported by 'substantial evidence on the record considered as a whole.'" 463 U.S. at 43-44 (citation omitted).

June 20, 2016) ("One of the basic procedural requirements of administrative rulemaking is that an agency must give adequate reasons for its decisions.").

A year after issuing its opinion in *State Farm*, the Court issued its opinion in *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). *Chevron* involved the Environmental Protection Agency's implementation of a statutorily mandated permit program regulating the "construction and operation of new or modified major stationary sources" of air pollution. 42 U.S.C. § 7502(b)(6) (1982). At issue was an EPA regulation adopting a "plantwide" definition of the statutory term "stationary source," thereby allowing existing plants containing several pollution-emitting devices to "install or modify one piece of equipment without meeting the permit conditions if the alteration [did] not increase the total emissions from the plant." 467 U.S. at 840.

The Court prefaced its analysis with the following discussion:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the

> unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

467 U.S. at 842-843 (fn. refs. omitted). This principle has come to be known as "*Chevron* deference." (ER46-47.) *See* 467 U.S. at 844 ("We have long recognized [the principle] that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations.") (fn. ref. omitted).

The Tax Court drew a distinction below between *State Farm* review and *Chevron* review by referring to the former as "Judicial Review of Agency Decisionmaking" and the latter as "Judicial Review of Agency Statutory Construction." (ER44, 46.) *State Farm* review focuses on the propriety of an agency's explanation of the reasons for its action, while *Chevron* review comes into play where the validity of the agency's action turns on the agency's interpretation of the statute it administers. *See, e.g., Dominion Res., Inc. v. United States*, 681 F.3d

1313, 1319 (Fed. Cir. 2012) (holding that a tax regulation was neither based on a permissible construction of the statute nor – inasmuch as Treasury "provided no rationale" for the rule – the product of reasoned decisionmaking).

The Commissioner argued below that the *Chevron* framework of analysis is the "superior choice" for adjudicating the validity of the 2003 cost-sharing amendments, primarily because *State Farm* review "is best suited to cases where Congress demands fact-finding and empirically-based solutions, but Congress made no such demands when it granted broad authority to Treasury under section 482." (ER90, 91.) The relevant point here is that reasoned decisionmaking in this context – *i.e.*, where the rulemaking process is not a fact-finding endeavor – simply means that "the process by which [the agency] reaches [its] result must be logical and rational." *Michigan v. E.P.A.*, 135 S. Ct. 2699, 2706 (2015) (internal quotation marks omitted) (focusing solely on whether the agency considered the relevant factors and all important aspects of the problem when it concluded that regulation of certain power plants was "appropriate and necessary"). As discussed below, the 2003 cost-sharing amendments easily satisfy that standard (and are based on a permissible construction of § 482, as required by *Chevron* step 2).

C. The Tax Court erred in failing to consider the effect of the coordinating amendments on the proper interpretation of § 1.482-1(b)(1)

The Tax Court's threshold – and, we submit, erroneous – conclusion that Treasury necessarily made an empirical determination in issuing the 2003 cost-sharing amendments was based primarily on its prior holding in *Xilinx* that "the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances." (ER52-53.) That *Xilinx* holding, in turn, was based on the third sentence of Treas. Reg. § 1.482-1(b)(1) (1994) (italicized below):

> A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). *However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.*

See Xilinx, 125 T.C. at 54-55. The Commissioner had argued in *Xilinx* that "[a] rule that applies only 'generally' must, by its own terms, have exceptions," and that "[i]n light of the legislative history and extensive regulations interpreting the [commensurate-with-income requirement]," the cost-sharing regulation was "an appropriate exception [to] the general rule" that the arm's-length result is determined by reference to comparable uncontrolled transactions. *Id.* at 55 (internal quotation marks omitted). The *Xilinx* court disagreed:

> Respondent's interpretation of the word "generally" is incorrect because he ignores the preceding clause (i.e., "because identical transactions can rarely be located"). The regulation simply states that "comparable transactions" are the broad exception when there are no identical transactions. … [*Id.*]

In the case at bar, the Tax Court erred in relying on its opinion in *Xilinx*; the court was instead obliged to revisit its interpretation of § 1.482-1(b)(1) in light of the coordinating amendments that post-dated the tax years at issue in that case. The *Xilinx* court, noting the absence of any regulatory language suggesting that Treasury could prescribe "an arm's-length result without reference to what [unrelated] parties" do, 125 T.C. at 55, merely declined to infer such authority from the word "generally" in the third sentence of § 1.482-1(b)(1) (providing that "whether a transaction produces an arm's length result generally will be determined by reference to" comparable uncontrolled transactions). The court acknowledged, however, that Treasury could "modify its regulations to resolve any conflict within the regulatory scheme." *Id.* at 58. Indeed, in discussing the 2003 promulgation of the SBC rule, the court also set forth the text of the coordinating amendments, and quoted at length from the discussion of those amendments in the preamble accompanying their issuance in proposed form. *See id.* at 48-49.

And therein lies the Tax Court's fundamental error in the case at bar: in concluding that the issue whether the final rule is consistent with the arm's-length standard presents an empirical question, the court relied on its interpretation of § 1.482-1(b)(1) within the pre-2003 regulatory scheme at issue in *Xilinx*, without considering whether the coordinating amendments governing later tax years render that interpretation untenable. *See, e.g., Maracich v. Spears*, 133 S. Ct. 2191, 2203 (2013) (noting that "an interpretation of a phrase of uncertain reach is not confined to a single sentence when the text of the whole statute gives instruction as to its meaning"). Those amendments plainly changed the legal landscape by making clear that, contrary to the Tax Court's conclusion below (ER53), the arm's-length standard in the context of a QCSA does *not* "require[ ] an analysis of what unrelated entities do under comparable circumstances." Because the Tax Court's reading of § 1.482-1(b)(1) in *Xilinx* has been superseded by regulatory clarification, the court erred in relying on that interpretation in resolving the case at bar.

For essentially the same reasons, the coordinating amendments supersede this Court's understanding of the arm's-length standard as reflected in its own *Xilinx* opinion. In that opinion, the Court did not rely on the Tax Court's analysis of the third sentence of § 1.482-1(b)(1) (relating to comparable uncontrolled transactions). Rather, the Court looked to the first sentence of that provision and concluded that the arm's-length standard itself – *viz.*, "the standard…of a taxpayer dealing at arm's length with an uncontrolled taxpayer" – precluded the Commissioner from applying the "all costs" requirement of § 1.482-7(d)(1) to require related parties to share stock-based compensation costs in light of evidence that uncontrolled parties do not share such costs. That understanding of the arm's-length standard, however, was reached without any consideration of the coordinating amendments, which were *not* applicable to the tax years at issue in *Xilinx*. Indeed, in his concurring opinion in *Xilinx*, Judge Fisher noted that it was an open question whether the flaws in the regulatory scheme before the Court had been remedied by the 2003 amendments at issue here. 598 F.3d at 1198 n.4. As demonstrated below, those amendments overcome the regulatory deficiencies that this Court identified in *Xilinx*.

D. The coordinating amendments are valid

1. The coordinating amendments are based on a permissible construction of § 482

It is clear that the Tax Court in the instant case did not address the "open question" identified by Judge Fisher in his concurring opinion in *Xilinx*. The court instead relied on its own prior opinion in *Xilinx* without giving any consideration to the effect of the coordinating amendments on the continuing viability of its analysis in that case. That was error.

There is no question that an agency faced with litigation over the meaning of one of its statute-implementing regulations is free to amend the regulatory scheme prospectively in order to clarify its position, provided the statute does not "'directly address[ ] the precise question at issue'" and the regulatory amendment "'is based on a permissible construction of the statute.'" *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 52, 54 (2011) (quoting *Chevron*, 467 U.S. at

843); *see id.* at 55 (noting that it is "immaterial to [the] analysis that a 'regulation was prompted by litigation'") (quoting *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 741 (1996)). Here, in the midst of litigation over whether Treasury could, consistent with the formulation of the arm's-length standard in § 1.482-1(b)(1), require cost-sharers to share all R&D-related costs as a condition to achieving an arm's-length result, Treasury amended the regulatory scheme to provide just that. Inasmuch as "[t]he parties agree that sec. 482 is ambiguous" and that "[t]hese cases would therefore be resolved at Chevron step 2" (ER55 n.16), Treasury's authority to issue the coordinating amendments turns on whether those amendments are based on a permissible construction of § 482.

a. The text of § 482

The first sentence of § 482 authorizes the Secretary to allocate certain tax items between commonly controlled entities "if he determines that such…allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such" entities. Implicit in that language is the recognition that, in order to clearly reflect income, commercial transactions between commonly controlled entities should be priced as though the parties had been dealing at arm's length (*i.e.*, the arm's-length standard). The second (and only other) sentence of § 482 – added nearly 60 years later – provides: "In the case of any transfer (or license) of intangible property [as defined elsewhere in the Code], the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Thus, in the context of intra-group transfers and licenses of intangible property, adherence to the arm's-length standard implicit in the first sentence of § 482 necessarily entails a comparison of the benefits realized by the two parties to the related-party transaction under scrutiny. The issue here is whether, based on the introduction of that internal (commensurate-with-income) benchmark for achieving an arm's-length result (and, by extension, a clear reflection of income), § 482 can be permissibly construed as authorizing a regulation that identifies the arm's-length result in the QCSA context based solely on the internal benchmark (*i.e.*, by requiring that all R&D-related costs be shared in proportion to reasonably anticipated benefits from the arrangement), without providing taxpayers an "escape hatch" based on evidence of what unrelated parties do (or do not do).

Little can be gleaned from the text of § 482 regarding the intended interaction between the commensurate-with-income requirement and traditional comparability analysis. By its terms, however, the commensurate-with-income requirement is an internal standard; its purview is limited to a comparison of the two sides of the related-party transaction. Such a purely internal requirement certainly *can* be implemented in conjunction with traditional comparability analysis, and Treasury has taken that approach outside the context of QCSAs. *See generally* Treas. Reg. §§ 1.482-4 – 1.482-6. By the same token, comparing the relative benefits realized by the parties to a related-party transaction does not *require* consideration of transactions between unrelated parties. It necessarily follows that a regulation identifying the arm's-length result in the QCSA context by reference to the basic economic terms a QCSA must incorporate in order to satisfy the commensurate-with-income requirement, without allowing any deviations founded on evidence (or the lack thereof) of transactions between unrelated parties, is based on a permissible construction of § 482.[14]

b. The 1986 legislative history

The legislative history of the commensurate-with-income requirement confirms that the coordinating amendments are based on a permissible construction of § 482. The 1986 House Report makes clear that the new rule was prompted by the Ways and Means Committee's belief that sales and licenses of intangible property between unrelated parties do not provide a sufficiently reliable basis of comparability to related-party transactions to be dispositive of the arm's-length result:

> A recurrent problem [under § 482] is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables.
>
> …
>
> …While the committee is concerned that [certain judicial] decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believes that such an approach is sufficiently troublesome where transfers of intangibles are

[14] It should be noted that various other aspects of § 1.482-7 do implicate traditional comparability analysis where appropriate. *See, e.g.*, Treas. Reg. §§ 1.482-7(g)(2), (3), (4), (5) (2003).

> concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles is necessary.
>
> …
>
> …There are extreme difficulties in determining whether the arm's length transfers [of intangibles] between unrelated parties are comparable [to the related-party transaction under scrutiny]. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation…be commensurate with the income attributable to the intangible. …
>
> …
>
> In making this change, the committee intends to make it clear that…unrelated party transactions do not provide a safe-harbor minimum payment for related party intangibles transfers. …

H.R. Rep. No. 99-426, at 423-425 (1985) (fn. ref. omitted).

The 1986 House Report also provides guidance regarding the practical implications of the commensurate-with-income requirement. In particular, the Ways and Means Committee contemplated that the new rule would require periodic adjustments to royalty payments to reflect actual profit experience:

> The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence

> of the transfer. Thus, the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. … [I]t will not be sufficient to consider only the evidence of value at the time of the transfer. … [*Id*. at 425-426.]

Viewed in the light of the 1986 House Report, the statutory commensurate-with-income requirement effectively established a presumption that a sale or license of intangible property between unrelated parties will not be deemed comparable to a related-party transaction for purposes of determining the arm's-length result unless it yields a price for the related-party transaction that satisfies the commensurate-with-income requirement.[15] And nothing in the 1986 House Report suggests that the periodic-adjustment requirement contemplated in that report would be subject to taxpayer veto based on evidence that agreements between unrelated parties do not provide for such adjustments. *See* A.W. Granwell & Bobbe Hirsh, *The Super Royalty: A New International Tax Concept*, 33 Tax Notes 1037, 1044

[15] Contrast that approach with that of a House-passed (but unenacted) amendment to § 482 in 1962, which would have authorized the Commissioner to allocate income from cross-border, intra-group sales of tangible property based on a formula, unless "the taxpayer [could] establish an arm's length price" based on comparability analysis. H.R. 10650, 87th Cong. § 6(a) (1962).

(Dec. 15, 1986) (stating that "this 'second look' approach is not consistent with third party commercial dealings"); 1 Cym H. Lowell *et al.*, *U.S. International Transfer Pricing* ¶ 1.02, at 1-5 (2d ed. 2000) (stating that "such open-ended licensing agreements are rare between independent parties").

It is the 1986 Conference Report, however, that provides the clearest indication that the coordinating amendments are based on a permissible construction of § 482:

> 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, *if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. 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. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit* as determined before deduction for research and development. …

H.R. Conf. Rep. No. 99-841, at II-638 (1986) (emphasis added).

The 1986 Conference Report is significant in several respects. First, it expressly conditions the continued use of related-party cost-sharing arrangements (addressed at § 1.482-2(d)(4) of the 1968 regulations) on their being consistent with the purpose of the statutory commensurate-with-income requirement. Second, it identifies that purpose in strictly internal economic terms: that "the division of income [from an intangible] between related parties reasonably reflect the relative economic activity undertaken by each." H.R. Conf. Rep. No. 99-841, at II-637. Third, it contemplates that a cost-sharing arrangement will generally satisfy that objective if costs are shared in proportion to profits. And fourth, it supports the notion that the cost pool should be comprehensive in scope. Moreover, as is the case with the periodic-adjustment requirement contemplated in the 1986 House Report, nothing in the 1986 Conference Report suggests that a taxpayer would be entitled to modify the basic parameters of the permissible cost-sharing arrangement envisioned in that report by marshaling evidence that allegedly comparable agreements between unrelated parties do not conform to those parameters in some respect. Taken together, the two committee reports confirm that the coordinating amendments are based on a permissible construction of § 482.

2. Treasury adequately explained the rationale behind the coordinating amendments

The coordinating amendments are also the result of reasoned decisionmaking. As discussed above (and as overlooked by the Tax Court), the coordinating amendments make clear that, in the context of a QCSA, the arm's-length standard does *not* "require[ ] an analysis of what unrelated entities do under comparable circumstances." (ER53.) Treasury's determination in that regard was not empirical; rather, it represented the agency's considered view regarding how Congress, in amending § 482 in 1986, intended the arm's-length standard to operate in the context of intangibles transactions in general, and cost-sharing arrangements in particular. *See* Richard W. Skillman, *The Problems with* Altera, 150 Tax Notes 347, 353 (Jan. 18, 2016) (noting that "Treasury was explaining its view of the meaning and scope of the arm's-length standard," not "making an empirical judgment like that underlying the seatbelt regulation that was invalidated in *State Farm*").

Thus, Treasury's promulgation of the coordinating amendments – as is the case with the overwhelming majority of tax regulations – did not require an "examin[ation] [of] data," "fact[-]f[i]nd[ing]," or consideration of "evidence before the agency." *State Farm*, 463 U.S. at 43. Reasoned decisionmaking in this context – *i.e.*, where the rulemaking process is not a fact-finding endeavor – simply means that "the process by which [the agency] reaches [its] result must be logical and rational." *Michigan v. E.P.A.*, 135 S. Ct. at 2706 (internal quotation marks omitted). Treasury's issuance of the coordinating amendments easily satisfies that standard. *See Balestra v. United States*, 803 F.3d 1363, 1374 (Fed. Cir. 2015) (holding that Treasury adequately explained its reasons for issuing a tax regulation that the court had already held was valid under *Chevron*; according to the court, Treasury's determination that the regulation was "simple, workable, and flexible" was "neither arbitrary nor capricious").

a. The preamble to the proposed regulations

The preamble accompanying the issuance of the 2003 cost-sharing amendments in proposed form (the "2002 preamble") begins with a discussion of the 1986 enactment of the commensurate-with-income requirement:

> The legislative history of the Act indicated that in adding this commensurate with income standard to section 482,

> Congress did not intend to preclude the use of bona fide research and development cost sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, "if and to the extent such agreements are consistent with the purpose of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs * * * ." H.R. Rep. No. 99-841, at II-638 (1986) (the Conference Report).
>
> The Conference Report recommended that the IRS conduct a comprehensive study and consider whether the regulations under section 482 (issued in 1968) should be modified in any respect. …

67 Fed. Reg. at 48,998 (alteration in original). The preamble then notes that the White Paper issued in response to the 1986 Conference Report "observed that Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm's length standard." *Id.* (citing Notice 88-123, 1988-2 C.B. at 477).

The 2002 preamble explains that the 1994 regulations formulated the arm's-length standard in terms of "the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." 67 Fed. Reg. at 48,998. The 1995 regulation, meanwhile, "implement[ed] the commensurate with income standard in the context of cost sharing arrangements" in accordance with the 1986 Conference Report by "requir[ing] that controlled participants in a [QCSA] share all costs incurred that are related to the development of intangibles in proportion to their shares of the reasonably anticipated benefits attributable to that development." *Id.* But when Treasury interpreted the "all costs" requirement to include "compensation…in the form of stock options," *id.*, affected taxpayers argued that if unrelated parties that engage in cost-sharing do not share such costs, then Treasury's interpretation would run counter to the arm's-length standard. Thus, the proposed amendments not only clarified that stock-based compensation expense is a "cost," but also "include[d] express provisions to coordinate the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1." *Id.*

The 2002 preamble clearly reveals that Treasury issued the coordinating amendments – effectively providing that, contrary to the Tax Court's view, the arm's-length standard does *not* "always require[ ] an analysis of what unrelated entities do under comparable circumstances" (ER53) – in order to implement legislative intent as expressed in the 1986 Conference Report. Treasury reasonably inferred that the conferees, in conditioning the use of cost-sharing arrangements on adherence to the cost-benefit allocation principle they identified as the purpose of the commensurate-with-income requirement, necessarily considered that purely economic benchmark to be consistent with the arm's-length standard. The coordinating amendments are entirely consistent with that economic-centric view of the arm's-length standard.

b. The preamble to the final regulations

In the preamble accompanying the issuance of the 2003 cost-sharing amendments in final form (the "2003 preamble"), Treasury noted that the comments it received were critical of the proposed amendments primarily "on the basis of interpretations of the arm's length standard." T.D. 9088, 2003-2 C.B. at 842. In particular, "[c]ommentators asserted that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard" in light of "third-party evidence…show[ing] that parties at arm's length do not take stock-based compensation into account" in somewhat similar circumstances. *Id.* In response, Treasury reiterated (*id.*) that it was acting "consistent[ly] with the legislative intent underlying section 482":

> The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing

> arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." The regulations relating to QCSAs implement that legislative intent by using costs incurred by each controlled participant with respect to the intangible development as a proxy for actual economic activity undertaken by each, and by requiring each controlled participant to share these costs in proportion to its anticipated economic benefit from intangibles developed pursuant to the arrangement. In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs.... ... [*Id.* (citation omitted).]

Treasury also stressed the theoretical bent of the arm's-length standard resulting from the 1994 revision of § 1.482-1(b)(1), pursuant to which a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances." T.D. 9088, 2003-2 C.B. at 842 (emphasis in original; internal quotation marks omitted).[16] The use

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[16] The 1993 temporary regulations had provided that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in a *comparable*

(continued...)

of the subjunctive "would" reinforces the conclusion that the proper inquiry is ultimately a hypothetical one that, in light of the 1986 Conference Report, is appropriately based on economic assumptions in this context. *Cf. Knight v. Commissioner*, 552 U.S. 181, 191 (2008) (noting that the term "would" in I.R.C. § 67(e)(1) "invites a hypothetical inquiry").

The 2003 preamble cogently explains why Treasury concluded that requiring QCSA participants to share stock-based compensation costs is consistent with the arm's-length standard, and, by extension, why providing for that result by regulation is itself consistent with the arm's-length standard. Referring to comments asserting that the SBC rule is inconsistent with the arm's-length standard in light of evidence that unrelated parties do not share such costs, Treasury responded that the only "interpretation[ ] of the arm's length standard" that matters – at least in the realm of domestic transfer pricing law – is Congress's. T.D. 9088, 2003-2 C.B. at 842. As it had in the 2002 preamble,

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(…continued)
transaction under *comparable* circumstances." Treas. Reg. § 1.482-1T(b)(1) (1993) (emphasis added); *see* T.D. 8470, 1993-1 C.B. 90, 101.

Treasury explained that the 1986 Conference Report contains very specific guidance regarding the circumstances under which a cost-sharing arrangement would be deemed to be consistent with the commensurate-with-income standard, a standard that Congress in turn deemed to be fully consistent with the arm's-length standard. *Id.* And, inasmuch as the 1986 Conference Report articulates the purpose of the commensurate-with-income requirement in purely economic (cost-benefit) terms, *id.*, it follows that Congress could not have subscribed to the rigid understanding of the arm's-length standard favored by those who submitted comments to the 2002 proposed amendments.

To be sure, the 2003 preamble contains some extraneous observations. For instance, since Treasury reasonably determined that it was statutorily authorized to dispense with comparability analysis in this narrow context, there was no need for it to establish that the uncontrolled transactions cited by commentators were insufficiently comparable. Similarly, the conclusion that the "all costs" requirement produces an arm's-length result is premised on the economic assumption that if unrelated parties could enter into the *same* transaction under the *same* circumstances – *i.e.*, if they could enter into a cost-sharing arrangement *from the same perspective as related entities* – they would agree to share all development-related costs.[17] That is the sense in which Treasury "considered whether unrelated parties would share stock-based compensation costs in the context of a QCSA." (ER53.)

The "reasoned decisionmaking" standard, however, is forgiving; as indicated above, the reviewing court must "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *State Farm*, 463 U.S. at 43 (internal quotation marks omitted); *see Montana Wilderness Ass'n v. Connell*, 725 F.3d 988, 999 n.9 (9th Cir. 2013) (concluding that the agency's "explanation was adequate under the circumstances," even though it "could have…[been] more complete"). Indeed, this Court has held that "[i]f an agency's determination is supportable on any rational basis, we must uphold it." *McFarland v.*

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[17] *Cf.* Treas. Reg. § 1.482-1(f)(2)(ii)(A) (1994) (providing that the IRS may consider any economically preferable "alternatives [actually] available to the taxpayer [engaging in the related-party transaction] in determining whether the terms of the [related-party] transaction" – although perhaps consistent with those observed in comparable uncontrolled transactions – would in fact "be acceptable to an uncontrolled taxpayer faced with the same alternatives" that are available to the taxpayer).

Kempthorne, 545 F.3d 1106, 1113 (9th Cir. 2008) (internal quotation marks omitted) (distinguishing *State Farm* on the ground that "the critical factor [there] was that the agency 'submitted no reasons at all' for its decision," *id.*, quoting *State Farm*, 463 U.S. at 50). Here, Treasury made clear that it viewed its conclusion regarding the arm's-length standard – *viz.*, that specifying the arm's-length result in this narrow context was consistent with that standard – as necessarily following from the 1986 Conference Report. And its discussion of that report reveals a rational basis for its conclusion in that regard. The reasoned decisionmaking standard requires nothing more in this context, where the agency is not engaged in a fact-finding endeavor. *See Drakes Bay Oyster Co. v. Jewell*, 747 F.3d 1073, 1087, 1088 n.8 (9th Cir. 2014) (agency explanation, which relied on "Congressional intent as expressed in [a] House committee report," established that the agency's "decision that [its action] would further Congress's earlier expressed [intent]…was rational").

E. The stock-based compensation rule is valid

The issue whether corporations incur a cost associated with the issuance of compensatory stock options is no more an empirical question than is the issue whether the arm's-length standard "always requires an analysis of what unrelated entities do under comparable circumstances." (ER53.) Thus, as is the case with the coordinating amendments, reasoned decisionmaking in the context of the SBC rule simply means that "the process by which [the agency] reache[d] [its] result [was] logical and rational." *Michigan v. E.P.A.*, 135 S. Ct. at 2706 (internal quotation marks omitted).[18] And, as is the case with the coordinating amendments, Treasury's issuance of the SBC rule easily meets that standard.

The 2002 preamble notes that "tax and other accounting principles" recognize that there is a "cost associated with stock-based compensation." 67 Fed. Reg. at 48,999. Thus, "[f]or general income tax purposes," an employer issuing compensatory stock options is generally entitled to a deduction "measured by the 'spread' between the option price and the fair market value of the underlying stock at the date of

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[18] Since, as demonstrated above, the coordinating amendments satisfy *Chevron* step 2, the SBC rule need not be separately analyzed under *Chevron*. That is, Treasury's statutory authority to require the sharing of all R&D-related costs as a condition to achieving an arm's-length result necessarily includes the reasonable identification of such costs.

exercise." *Id.*; *see* I.R.C. § 83(h); Treas. Reg. § 1.83-7(a) (1978). The 2002 preamble further notes that, since October 1995, the Financial Accounting Standards Board (FASB) had required companies to report stock-based compensation expense – based on grant-date value – "either as a charge to income or, at the company's option, in a pro forma footnote disclosure." 67 Fed. Reg. at 48,999. Although Treasury agreed (in response to comments to the proposed amendments) that "the disposition of financial reporting issues [with respect to stock-based compensation expense] does not *mandate*" similar treatment under the cost-sharing regulations, T.D. 9088, 2003-2 C.B. at 843 (emphasis added), FASB's recognition of stock-based compensation as a cost plainly provides a rational basis for Treasury's decision to specify (in § 1.482-7(d)(2)) that the term "operating expenses" includes stock-based compensation expense. And, once the status of stock-based compensation as a cost is accepted, there is simply no rational basis "for distinguishing between stock-based compensation and other forms of compensation in this context." *Id.* at 842.

F. A final word on the arm's-length standard

As demonstrated in Part D of the Argument, *supra*, Treasury's rationale for issuing the coordinating amendments was founded on its understanding of how Congress, in enacting the commensurate-with-income requirement in 1986, intended the arm's-length standard to operate in the context of intangibles transactions in general, and cost-sharing arrangements in particular. That understanding posits that Congress necessarily viewed the descriptor "arm's-length" as a term of art, since it contemplated that adherence to the arm's-length principle implicit in § 482 could be premised on economic assumptions regarding how unrelated parties would price the same transaction under the same circumstances (*i.e.*, that they would "divi[de] [the] income" attributable to the intangible in a manner that "reasonably reflect[s] the relative economic activity undertaken by each"), rather than by reference to observed transactions between unrelated parties. H.R. Conf. Rep. No. 99-841, at II-637.

In his concurring opinion in *Xilinx*, Judge Fisher recognized that there is indeed more than one way of looking at the arm's-length standard:

> 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 in situations where related and unrelated parties always occupy materially different circumstances. As applied to sharing [stock-based compensation] costs, the Commissioner argues (consistent with the tax court's findings) that the *reason* unrelated parties do not, and would not, share [such] costs is that they are unwilling to expose themselves to an obligation that will vary with an unrelated company's stock price. Related companies are less prone to this concern precisely because they are related – i.e., *because* [Xilinx Ireland] is wholly owned by Xilinx, it is already exposed to variations in Xilinx's overall stock price, at least in some respects. In situations like these, the Commissioner reasons, the arm's length result must be determined by some method other than analyzing what unrelated companies do in their joint development transactions.
>
> …
>
> …In particular, the Commissioner argues that, because there are material differences in the economic circumstances of related and unrelated companies in relation to cost-sharing agreements like the one in this case, it was proper for the IRS to require that in this narrow context the arm's length result should be defined by the 'all costs' requirement [of § 1.482-7(d)(1)].

598 F.3d at 1197, 1198 (Fisher, J., concurring) (emphasis in original); *see also id.* at 1199 (Reinhardt, J., dissenting) (noting that "[c]ontrolled and uncontrolled parties always operate under materially different circumstances with regard to employee stock option costs").

The arm's-length standard therefore is susceptible to more than one understanding. As a leading academic in this field explained:

> Consequently, the words "arm's length" can be used in two ways to refer to two different possible ranges of solutions to the transfer pricing problem. Under the traditional or narrow definition, "arm's length" refers to methods of determining transfer prices by using comparables, and encompasses only the [comparable uncontrolled price], cost plus and resale price methods.[19] On the other hand, "arm's length" can also be used to refer to any method of determining transfer prices that reaches results (i.e., a profit allocation) that are the same as those that *would have been* reached between unrelated parties [*i.e.*, had they engaged in the same transaction under the same circumstances]. …

Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 Va. Tax Rev. 89, 94 (Summer 1995) (fn. ref. omitted; emphasis and final clause added); *see also* Durst & Culbertson, 57 Tax L. Rev. at 69 (referring to "the arm's length standard as it previously had been conceived," *i.e.*, prior to the 1986 Act and the White Paper); Lee A. Sheppard, *Transfer Pricing Needs a Save Shot*, 151 Tax Notes 543, 550 (May 2, 2016) (noting the "general acceptance of deviations from the idea that the arm's-length method always equals what unrelated parties choose to do," and that

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[19] The enumerated methods are those that were set forth in the 1968 regulations. *See* Treas. Reg. § 1.482-2(e)(2), (3), (4) (1968).

"what is called the arm's-length standard has been institutionalized as a flexible doctrine for determination of transfer pricing cases to get to a sensible result").[20] We respectfully submit that, because Treasury is the agency charged with administering § 482, its understanding of the arm's-length standard – which, as demonstrated above, is based on a permissible construction of that statute – must prevail.

[20] *See generally* Edward B. Dix, Note, *From General to Specific: The Arm's-Length Standard's Evolution and its Relevancy in Determining Costs To Be Shared in Cost-Sharing Agreements*, 64 Tax Law. 197 (Fall 2010).

CONCLUSION

The decisions of the Tax Court are erroneous and should be reversed.

Respectfully submitted,

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STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, counsel for the Commissioner respectfully inform the Court that they are not aware of any cases related to the instant appeal that are pending in this Court.

ADDENDUM

Internal Revenue Code (26 U.S.C.):

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Treasury Regulations (26 C.F.R.):*

§ 1.482-1 Allocation of income and deductions among taxpayers.

(a) *In general* – (1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. * * *

*   *   *   *   *

(b) *Arm's length standard* – (1) *In general.* In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length

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* As in effect during the years at issue.

standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See § 1.482-1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482-1(c).

> (2) *Arm's length methods* – (i) *Methods.* Sections 1.482-2 through 1.482-6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result. 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.

* * * * *

(c) *Best method rule* – (1) *In general.* The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. * * * See § 1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

* * * * *

(i) *Definitions.* The definitions set forth in paragraphs (i)(1) through (10) of this section apply to §§ 1.482-1 through 1.482-8.

* * * * *

> (5) *Controlled taxpayer* means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. *Uncontrolled taxpayer* means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.

*   *   *   *   *

(8) *Controlled transaction* or *controlled transfer* means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term *uncontrolled transaction* means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers.

(9) *True taxable income* means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. * * *

*   *   *   *   *

§ 1.482-5 Comparable profits method.

*   *   *   *   *

(d) *Definitions.* The definitions set forth in paragraphs (d)(1) through (6) of this section apply for purposes of this section.

*   *   *   *   *

(3) *Operating expenses* includes all expenses not included in cost of goods sold except for interest expense, foreign income taxes (as defined in § 1.901-2(a)), domestic income taxes, and any other expenses not related to the operation of the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.

*   *   *   *   *

§ 1.482-7 Sharing of costs.

(a) *In general* – (1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. 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. * * *

*   *   *   *   *

> (2) *Limitation on allocations.* The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as defined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. * * *
>
> (3) *Coordination with § 1.482-1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482-1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

*   *   *   *   *

(b) *Qualified cost sharing arrangement.* A qualified cost sharing arrangement must –

> (1) Include two or more participants;
>
> (2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;
>
> (3) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes –

(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;

(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;

(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;

(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area);

(v) The duration of the arrangement; and

(vi) The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

* * * * *

(d) *Costs* – (1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in § 1.482-5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482-5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. * * *

* * * * *

(2) *Stock-based compensation* – (i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

*   *   *   *   *

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With Type-Volume Limitation, Typeface Requirements, and Type Style Requirements of Federal Rule of Appellate Procedure 32(a)

Case Nos. 16-70496, 16-70497

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(s) /s/ Arthur T. Catterall

Attorney for the Commissioner

Dated: June 27, 2016

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing brief with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on June 27, 2016.

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/s/ Arthur T. Catterall
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