# 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

## SUPPLEMENTAL BRIEF FOR THE APPELLANT


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## GLOSSARY

Altera Br. – Altera's answering brief, filed September 9, 2016

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

Gov't Br. – the Commissioner's opening brief, filed June 27, 2016

I.R.C. (or Code) – Internal Revenue Code (26 U.S.C.)

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)

Op. – opinion of the Court issued in this appeal on July 24, 2018 and withdrawn on August 7, 2018

QCSA – qualified cost-sharing arrangement

Reply Br. – the Commissioner's reply brief, filed November 10, 2016

R&D – research and development

Treas. Reg. – Treasury Regulations (26 C.F.R.)

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

## PROCEDURAL BACKGROUND

In an opinion issued July 24, 2018 ("Op."), a divided panel of this Court ruled in favor of the appellant Commissioner of Internal Revenue in these consolidated appeals, holding that the 2003 amendments to Treas. Reg. §§ 1.482-1 and 1.482-7 (the "2003 cost-sharing amendments") are substantively and procedurally valid. On August 7, 2018, the Court – having previously announced that Judge Graber had been drawn as a replacement judge for the late Judge Reinhardt – withdrew its prior opinion "to allow time for the reconstituted panel to confer on this appeal." *Altera Corp. v. Commissioner*, 898 F.3d 1266 (9th Cir. 2018) (Mem.). The Court then set a re-argument date of October 16, 2018, and invited the parties to file optional supplemental briefs on or before September 28, 2018. The Commissioner is filing this brief in response to that invitation.

## INTRODUCTION

The first sentence of I.R.C. § 482 – the substance of which dates back to 1928 – grants the Commissioner broad authority to allocate income and deductions among commonly controlled entities "in order to prevent evasion of taxes or clearly to reflect the income" of such entities.

The Commissioner typically exercises this authority by adjusting the prices of related-party transactions. *See* Treas. Reg. § 1.482-1(a)(1) (1994) ("The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions…."). This practice has spawned an area of tax law commonly referred to as "transfer pricing." *See* Op. 5.

Since 1935, the regulations under § 482 have provided that, in evaluating whether the results of a related-party transaction clearly reflect the parties' respective incomes, the "standard to be applied in every case" is that of a taxpayer "dealing at arm's length with" an unrelated party. Treas. Reg. § 1.482-1(b)(1) (1994) (first sentence); *see* Treas. Reg. 86, Art. 45-1(b) (1935) (last sentence of first paragraph). In response to a Congressional directive calling for additional guidance under § 482, Treasury issued final regulations in 1968 that focused – for the first time – on determining compliance with the arm's-length standard by reference to "comparable uncontrolled" transactions. *See* Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 649 (Feb. 17, 1986) (referring to the "utter novelty of the [1968] regulations' focus on finding 'comparables'").

The 1968 regulations also introduced the concept of the "bona fide cost sharing arrangement," an alternative to related-party licensing agreements with respect to intangible property. The regulation defined the term 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). Consistent with the overall approach of the 1968 regulations, the cost-sharing rule provided that, "[i]n 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.*

By 1986, Congress had become sufficiently concerned about courts "unduly emphasiz[ing] the concept of comparables" – especially "in the case of transfers of high-profit potential intangibles," where "the recurrent problem [of] the absence of comparable…transactions between unrelated parties" was "particularly acute" – to conclude that "a statutory modification to the intercompany pricing rules regarding

transfers of intangibles [was] necessary." H.R. Rep. No. 99-426, at 423-424 (1985). That modification took the form of a second sentence added to § 482 in 1986: "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."[1]

The Conference Report accompanying the 1986 legislation explains that, "[i]n 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." H.R. Conf. Rep. No. 99-841, at II-638 (1986). The report further provides that, "[u]nder such a bona fide cost sharing arrangement, the cost-sharer would be expected to

[1] In December 2017, Congress added a third sentence to § 482, and in March 2018, it changed the statutory cross-reference in the second sentence to § 367(d)(4) to reflect concurrent changes in the Code.

bear its portion of all research and development costs," and that "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…." *Id.* Recognizing that "many important and difficult issues under section 482 are left unresolved by this legislation," the conferees stated that "careful consideration should be given to whether the existing regulations could be modified in any respect." *Id.*

In response to the concerns expressed by Congress, Treasury overhauled the existing (1968) regulations in a process that began with the publication of an exhaustive study in 1988, *see* Gov't Br. 9-10, and culminated in the issuance of final regulations in 1994 (as relevant here, §§ 1.482-1 through 1.482-6, addressing everything but cost-sharing) and 1995 (§ 1.482-7, addressing cost-sharing). The 1994 regulations provided that "[s]ections 1.482-2 through 1.482-6 provide specific methods to be used to…determine the arm's length result," including profits-based alternatives to existing methods dependent on the existence of comparable transactions. Treas. Reg. § 1.482-1(b)(2)(i) (1994). Meanwhile, the 1995 cost-sharing regulation provided that the

IRS "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…of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development." Treas. Reg. § 1.482-7(a)(2) (1995).

In *Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), a divided panel of this Court held that, as applied to stock-based compensation costs, the requirement in Treas. Reg. § 1.482-7(d)(1) (1995) that *all* costs related to the intangible development area be shared could not be reconciled with the arm's-length standard set forth in § 1.482-1(b)(1) in light of evidence that unrelated parties entering into similar types of arrangements did not agree to share such costs.[2] In a concurring opinion, Judge Fisher recognized that the case involved "dueling interpretations of the 'arm's length standard'" articulated in

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[2] In an earlier, withdrawn opinion, the panel had concluded that the stock-based compensation costs at issue were "costs" that were "related to" the intangible development area within the meaning of the cost-sharing regulation. *See Xilinx Inc. v. Commissioner*, 567 F.3d 482, 493-496 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010).

§ 1.482-1(b)(1), and that under the Commissioner's interpretation, "comparable transactions analysis is not always dispositive" of the arm's-length result, *i.e.*, that in certain "narrow context[s]," "the arm's length result must be determined by some method other than analyzing what unrelated companies do" in similar types of arrangements. *Id.* at 1197, 1198 (Fisher, J. concurring). He concluded, however, that the Court was not obliged to defer to the Commissioner's interpretation "because he has not clearly articulated his rationale until now," such that "taxpayers have not been given clear, fair notice of how the regulations will affect them." *Id.* at 1198. Judge Fisher then noted that the efficacy of "the new regulations Treasury issued after the tax years at issue in" *Xilinx* – the 2003 cost-sharing amendments at issue in the instant case – "is an open question." *Id.* at 1198 n.4.

As noted by Judge Fisher in his *Xilinx* concurrence, the 2003 cost-sharing amendments (not at issue in that case) "stat[e] explicitly" what the Commissioner had argued was implicit in the 1995 cost-sharing regulation. *Xilinx*, 598 F.3d at 1198 n.4 (Fisher, J., concurring). First, they stated explicitly that stock-based compensation costs – like any other compensation expense – are "costs" for purposes of the cost-

sharing regulation. *See* Treas. Reg. § 1.482-7(d)(2) (2003). Second, they stated explicitly 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." Treas. Reg. § 1.482-7(a)(3) (2003); *see also* Treas. Reg. § 1.482-1(b)(2)(i) (2003) (collectively, the "coordinating amendments").

Based on its belief that "the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances," the Tax Court held in this case that the 2003 cost-sharing amendments are "arbitrary and capricious and therefore invalid," leading to the present appeal. (ER12, 52-53.) For the reasons discussed below, the majority in the withdrawn opinion in this appeal correctly held (Op. 8) that "the challenged regulations are not arbitrary and capricious but rather a reasonable execution of the authority delegated by Congress to Treasury."

## ARGUMENT

### I. The majority correctly held that the 2003 cost-sharing amendments reflect a permissible understanding of the arm's-length standard

We begin with the majority's observation (Op. 8) that the open question identified by Judge Fisher in his *Xilinx* concurrence – which "the Tax Court clear[ly]…did not address" (Gov't Br. 48) – "is not what the arm's length standard should mean but rather whether Treasury may define the standard as it has." To put a finer point on it, that issue distills to whether Treasury's understanding of the arm's-length standard of § 1.482-1(b)(1) ("the standard…of a taxpayer dealing at arm's length with an uncontrolled taxpayer") – as that understanding is reflected in the 2003 cost-sharing amendments, which require related parties in a qualified cost-sharing arrangement (QCSA) to share *all* R&D-related costs in a prescribed ratio as a condition to achieving an arm's-length result – comports with both the regulatory language quoted above and the authority delegated to Treasury under I.R.C. § 482. As demonstrated below, Treasury's understanding of the arm's-length standard clears both of those hurdles.

### A. The majority correctly rejected Altera's argument that the regulatory arm's-length standard, by its terms, is inextricably tied to comparability analysis

As the majority observed (Op. 7), "Altera asserts that the arm's length standard always demands a comparability analysis, meaning [in the present context] that the Commissioner cannot" require related participants in a QCSA to share a particular cost "in the absence of evidence that unrelated parties share th[at]…cost[ ] when dealing at arm's length," *i.e.*, when they enter into similar types of arrangements. To be sure (and as the majority acknowledged, *id.*), there is a school of thought that adheres to that view, which is sometimes referred to as the "traditional" approach. *See, e.g.*, 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) (noting that the "traditional or narrow definition…[of] 'arm's length' refers to methods of determining transfer prices by using comparables"). But as the majority demonstrated (Op. 14-17), that rigid view has not been shared by all interested parties through the years.

The majority began its historical analysis by noting (Op. 13, 14) that the regulatory "arm's length standard first appeared in the

[Revenue Act of] 1934 tax regulations" "in what is essentially its modern form": "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Regulations 86, Art. 45-1(b) (1935). As the majority demonstrated, courts applying § 482's predecessor found the arm's-length standard to be anything but self-explanatory in the manner that Altera suggests it is, and they did not reflexively "look[ ] for comparable transactions" (Op. 14) between unrelated parties in resolving transfer-pricing disputes. *See, e.g.*, *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215, 1233 (1945) (finding the transaction to be "fair" and therefore "entitled to classification as an arm's length transaction"); *Palm Beach Aero Corp. v. Commissioner*, 17 T.C. 1169, 1176 (1952) (equating "fair consideration" with "arm's length dealing"); *see also Oil Base, Inc. v. Commissioner*, 362 F.2d 212, 214 n.5 (9th Cir. 1966) (referring to the need to "*hypothesize* an arm's-length transaction" for purposes of § 482) (emphasis added).

The majority further recognized (Op. 16) that this broader view of the arm's-length standard appears to have been shared by Congress in 1962, when the House of Representatives included a provision in its

version of the Revenue Act of 1962 that would have overhauled § 482. As the Ways and Means Committee explained, the impetus for the amendment was that "in practice[,] the difficulties in determining a *fair price* under this provision severely limit [its] usefulness." H.R. Rep. No. 87-1447, at 28 (1962) (emphasis added). And the Conference Committee's explanation of the House conferees' agreement to accede to the Senate's omission of the § 482 amendment from its own version of the Act is even more revealing.

As the 1962 Conference Report explains, the § 482 amendment in the House bill contained a default rule that would have authorized the Commissioner to allocate income from cross-border, intra-group sales of tangible property between the U.S. entity and the foreign entity based on a multi-factor formula. H.R. Conf. Rep. No. 87-2508, at 18 (1962); *see* H.R. 10650, 87th Cong. § 6(a) (1962). The House agreed to drop this provision, the report explains, because –

> [t]he conferees on the part of both the House and the Senate believe that the objectives of section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present section 482. Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions. It is believed that the Treasury should explore the possibility of developing and promulgating regulations under this

> authority which would provide additional guidelines *and formulas* for the allocation of income and deductions in cases involving foreign income.

H.R. Conf. Rep. No. 87-2508, at 18-19 (emphasis added). This suggests that the 1962 conferees understood the arm's-length standard – a staple of the regulations for over a quarter-century by then – to be consistent with formulaic approaches, which occupy the opposite end of the transfer-pricing spectrum from pure comparability analysis. *See* Op. 16; *see also* Avi-Yonah, 15 Va. Tax Rev. at 94 (noting that, in its "broader sense," the term "'arm's length' can be used to refer to the entire transfer pricing continuum," including formulaic approaches).

Under this broader conception of the arm's-length standard, which views the standard as "aspirational, not descriptive" (Op. 43), the term "'arm's length'…refer[s] to any method of determining transfer prices that reaches results" that are deemed to be "the same as those that would have been reached between unrelated parties" had they hypothetically engaged in the same transaction under the same circumstances. Avi-Yonah, 15 Va. Tax Rev. at 94; *see* Lee A. Sheppard, *Transfer Pricing Needs a Save Shot*, 151 Tax Notes 543, 550 (May 2, 2016) (noting that "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"). Indeed, this broader, "results-oriented" (Op. 7, 22) understanding of the arm's-length standard is reflected in the 1994 regulations, which for the first time amplified the arm's-length standard in terms of the hypothetical "arm's-length result." *See* Treas. Reg. § 1.482-1(b)(1) (second sentence) (referring to "the results that would have been realized if the uncontrolled taxpayers had engaged in the *same* transaction under the *same* circumstances") (emphasis added).[3]

Thus, as the majority's historical analysis conclusively demonstrates, Treasury's understanding of the arm's-length standard – as that understanding is reflected in the 2003 cost-sharing amendments, which require related parties in a QCSA to share *all*

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[3] As explained in our opening brief (Gov't Br. 62 n.16), the theoretical bent of this explication is further demonstrated by the fact that the 1993 temporary regulations had referred to "the results that would have been realized if uncontrolled taxpayers had engaged in a *comparable* transaction under *comparable* circumstances." Treas. Reg. § 1.482-1T(b)(1) (1993) (emphasis added); *see* T.D. 8470, 1993-1 C.B. 90, 101.

R&D-related costs in a prescribed ratio as a condition to achieving an arm's-length result – comports with the language of § 1.482-1(b)(1).

### B. The majority correctly held that the 2003 cost-sharing amendments reflect a permissible construction of § 482

That the 2003 cost-sharing amendments reflect an understanding of the arm's-length standard that comports with the language of § 1.482-1(b)(1) would be of no practical consequence if that understanding did not itself reflect a permissible construction of § 482, which "provides the statutory authority for the arm's length standard" (Op. 13). As the majority correctly observed (*id.* at 14), "the concern expressed on the face of § 482…is preventing tax avoidance by controlled taxpayers." And that has always been the case. *See* Revenue Act of 1928, ch. 852, § 45, 45 Stat. 791, 806. Thus, "[f]rom the beginning, § 482's precursor was designed to give Treasury the flexibility it needed to prevent cost and income shifting between related entities for the purpose of decreasing tax liability." Op. 13 (citing H.R. Rep. No. 70-2, at 16-17 (1927), which refers to "the shifting of profits… and other methods frequently adopted for the purpose of 'milking'"). Implicit in the "milking" concept is the notion that, in order to clearly

reflect income, commercial transactions between commonly controlled entities should be priced as though the parties were unrelated, *i.e.*, dealing at arm's length. *See* Gov't Br. 49-50.

Little can be gleaned from the text of that first sentence of § 482 – which was the *only* sentence until 1986 – regarding whether Congress contemplated that Treasury could enforce the arm's-length standard implicit therein without reference to evidence of how unrelated parties behave in allegedly similar circumstances (or evidence of how they allegedly would behave in the same circumstances). As previously discussed (and as the majority recognized, Op. 16), Congress apparently believed in 1962 that Treasury had the authority under that lone sentence of § 482 to implement a formulaic approach. Significantly, however, that proposed legislation provided an "escape hatch"; that is, it allowed Treasury to apply the formulaic approach "unless the taxpayer [could] establish an arm's length price" based on the precursor of comparability analysis. H.R. 10650, 87th Cong. § 6(a) (1962) (proposed § 482(b)(1), (4)).

Any suggestion, however, that Congress viewed the arm's-length standard as *requiring* Treasury to provide taxpayers such an

evidentiary "escape hatch" from any rule enforcing the standard on the basis of economic assumptions – such as the coordinating amendments at issue here – was laid to rest with the addition of the second sentence to § 482 in 1986: "In the case of any transfer (or license) of intangible property…, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By its terms, the commensurate-with-income requirement dictates a result ("shall be commensurate with") that is expressed in terms of a comparison of the two sides of the related-party transaction (rather than a comparison of the related-party transaction to uncontrolled transactions), without a "fall-back" provision (like the one contained in the proposed 1962 legislation) grounded in comparability analysis. Thus, as a textual matter, Treasury's understanding of the arm's-length standard of § 1.482-1(b)(1), as that understanding is reflected in the 2003 cost-sharing amendments, reflects a permissible construction of § 482.

The majority's *Chevron* step-two analysis (Op. 39-42) – *i.e.*, its "consider[ation] whether Treasury's interpretation of § 482 as to allocation of employee stock option costs is permissible" (*id.* at 39) –

echoes the foregoing discussion. Noting that "Congress's purpose in enacting and amending § 482 in 1986 is key to resolution of this issue," the majority correctly concluded that "[t]he 1986 amendment reflected Congress's recognition that the traditional [approach to the] arm's length standard did not serve the purpose of § 482." *Id.*; *see supra* p. 15. The majority further correctly recognized (Op. 39) that the commensurate-with-income requirement, by its terms, "is a purely internal standard," and that the legislative history of the 1986 Act "supports Treasury's belief that Congress intended it to be." *See* H.R. Conf. Rep. No. 99-841, at II-637 (defining "the objective" of the new requirement as ensuring "that the division of income [from an intangible] between related parties reasonably reflect the relative economic activity undertaken by each"). Moreover, that legislative history "supports Treasury's application of the commensurate with income standard in the QCSA context." Op. 39; *see supra* pp. 4-5. Accordingly, "Treasury's decision to dispense with a comparability analysis [in the context of QCSAs] was reasonable." Op. 40.

The majority also recognized that "Treasury's determination that uncontrolled cost-sharing arrangements do not provide helpful guidance

regarding allocations of employee stock compensation" "is entirely consistent with Congress's rationale for amending § 482 in the first place." Op. 40 (citing H.R. Rep. No. 99-426, at 423-425); *see supra* pp. 3-4. As explained in our reply brief, the 1986 House Report reflects Congress's conclusion that the comparability of uncontrolled transactions involving intangible property "is sufficiently problematic to require preemptive reliance on an economic assumption regarding how unrelated parties would price the related-party transaction under scrutiny." Reply Br. 9-10. And the 1986 Conference Report spells out that economic assumption in the context of cost-sharing arrangements: "[T]he cost-sharer would be expected to bear its portion of *all* research and development costs…[in] proportion[ ] to profit" it anticipates from the arrangement. H.R. Conf. Rep. No. 99-841, at II-638 (emphasis added). Stated differently, "the amendment was intended to hone the definition of the arm's length standard" in the context of intangible property "so that it could work to achieve arm's length results instead of forcing application of" methods entailing "a constant search for comparables" that often do not exist. Op. 41 (citing H.R. Rep. No. 99-426, at 423). Treasury therefore "reasonably understood" the

amendment as "an authorization to require internal allocation methods" – in the form of the sharing ratio set forth in the 1986 Conference Report – "in the QCSA context." *Id*. at 42.

The majority also correctly dispensed with certain counter-arguments raised by Altera and its amici (Op. 42-46). First, it rejected Altera's argument that, in light of the canon of construction that disfavors amendments by implication, the addition of the commensurate-with-income requirement to § 482 in 1986 cannot be construed as "chang[ing] the meaning and operation of the arm's-length standard" (*id*. at 42). Finding the canon inapplicable here, the majority noted that the canon "operates to prevent courts from attributing unspoken motives to legislators, not to force courts to ignore legislative action." *Id*.; *see* Reply Br. 11-12, 12-13.

Next, the majority rejected Altera's argument that Treasury's interpretation of § 482 (as reflected in the 2003 cost-sharing amendments) conflicts with the United States's obligations under its network of tax treaties, almost all of which incorporate the arm's-length standard (often in Article 9, paragraph 1). In addition to taking issue with the notion that "the unworkable empiricism for which Altera

argues is also incorporated into our treaty obligations," Op. 43, the majority correctly noted that Treasury's Technical Explanations of our treaties post-dating the issuance of the 2003 cost-sharing amendments – explanations that Altera itself argues (Altera Br. 70) are entitled to "'great weight'" – provide that the commensurate-with-income standard "'operates consistently with the arm's-length standard,'" and that "'[t]he implementation of this standard *in the regulations under Code section 482* is in accordance with the general principles of paragraph 1 of Article 9 of the [treaty].'" Op. 43 (emphasis and alterations added, citation omitted); *see* Reply Br. 20-21.

Finally, the majority rejected the argument (raised in the brief filed by one of Altera's amici, Xilinx) "that the outcome of this case is controlled by [this] Court's decision in *Xilinx*" (Op. 44). As the majority correctly recognized (*id.*), *Xilinx* involved the interpretation of §§ 1.482-1(b)(1) (1994) and 1.482-7(d)(1) (1995), whereas the instant case involves Treasury's authority to issue subsequent regulations that state explicitly what the Commissioner had argued in *Xilinx* was implicit in the 1994 and 1995 regulations. Thus, "[t]he *Xilinx* panel did not address the 'open question'" regarding the efficacy of the 2003 cost-

sharing regulations. Op. 45 (quoting *Xilinx*, 598 F.3d at 1198 n.4 (Fisher J., concurring)); *see supra* pp. 6-7.

## II. The majority correctly held that Treasury complied with the APA

As the majority explained (Op. 27), Altera asserts that Treasury "did not adequately consider and respond to" the comments it had solicited with respect to the 2003 cost-sharing amendments in their proposed form, "rendering the regulations arbitrary and capricious under [*Motor Vehicle Mfrs. Ass'n v.*] *State Farm* [*Mut. Auto Ins. Co.*, 463 U.S. 29 (1983)]." That argument, in turn, "is premised on: (1) Treasury's rejection of the comments submitted in opposition to the proposed rule, and (2) Altera's claim that Treasury's current litigation position is inconsistent with statements made during the rulemaking process." *Id*. at 28. The majority correctly rejected Altera's argument in this regard.

The majority began by noting that "[i]f the comments to which the agency did not respond would not bear on the agency's 'consideration of the relevant factors,' the court may not reverse the agency's decision." Op. 29 (citing *Am. Mining Congress v. EPA*, 965 F.2d 759, 771 (9th Cir. 1992)). Here, Treasury explained in the 2002 notice of proposed

rulemaking that it had intended the 1995 cost-sharing regulation to "implement[ ] 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." Notice of Proposed Rulemaking, *Compensatory Stock Options Under Section 482*, 67 Fed. Reg. 48,997, 48,998 (July 29, 2002); *see* H.R. Conf. Rep. No. 99-841, at II-638. Treasury further explained that when it interpreted the 1995 "all costs" requirement to include "compensation…in the form of stock options," questions arose "regarding the interaction between the arm's length standard and the cost sharing regulations" in light of taxpayer allegations that unrelated parties entering into similar types of arrangements do not share such costs. 67 Fed. Reg. at 48,998. In response to those questions, the proposed amendments clarified Treasury's position on stock-based compensation costs and 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.*,

thereby giving affected parties the opportunity to formally articulate their views on the subject.

As the majority further explained (Op. 29), "[c]ommenters responded by attacking the proposed regulations as inconsistent with the traditional arm's length standard," pointing to similar types of arrangements between "unrelated parties [which] did not mention employee stock options." In the preamble to the final version of the amendments, however, Treasury essentially "dismissed the comments (and, relatedly, the behavior of [un]controlled taxpayers) as irrelevant." *Id.* The majority then quoted at length from that 2003 preamble (*id.* at 30-31), correctly concluding (*id.* at 31) that, "[w]ith its references to legislative history, Treasury communicated its understanding that Congress had called upon it to move away from the traditional [approach to the] arm's length standard" – where comparability analysis is potentially relevant in every situation – to the broader, "results-oriented" approach (*id.* at 7, 22). *See supra* pp. 10, 13-14.[4]

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[4] As the majority had previously demonstrated (Op. 14-17), the broader approach actually pre-dates the "traditional" approach emphasized in the 1968 regulations.

In a paragraph that encapsulates why Altera's APA argument must fail, the majority stated:

> In short, the objectors were arguing that the evidence they cited – showing that unrelated parties do not share employee stock compensation costs – proved that Treasury's commensurate with income analysis did not comport with the arm's length standard. Thus, the thrust of the objection was that Treasury misinterpreted § 482. But that is a separate question – one properly addressed in the *Chevron* analysis. *That commenters disagreed with Treasury's interpretation of the law does not make the rulemaking process defective.*

Op. 31-32 (emphasis added). Rather, the issue under the APA "is whether Treasury's references to legislative history gave interested parties notice of its proposal and an opportunity to respond to it." *Id.* at 32. The majority correctly held that those references "make clear enough why Treasury believed it could require related parties to share all costs – including employee stock compensation – in proportion to the income enjoyed by each." *Id.*; *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").

Accordingly, "Treasury's refusal to credit oppositional comments is not fatal to a holding that it complied with the APA." Op. 32.

The majority also correctly rejected (Op. 33) Altera's argument that our *Chevron* analysis of the coordinating amendments – *i.e.*, our explanation why those amendments reflect a permissible construction of § 482, *see* Gov't Br. 48-57 – is somehow barred by *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947), which holds that "a reviewing court…must judge the propriety of [agency] action solely by the grounds invoked by the agency." As explained in our reply brief at p. 23 – and as the majority correctly recognized (Op. 29-33) – Treasury justified the coordinating amendments on the ground that they implemented legislative intent. Our opening brief did not purport to offer additional grounds on which the validity of those amendments may be upheld, as *Chenery* prohibits; rather, it simply explained more fully *why* Treasury was justified in concluding that the amendments were consistent with legislative intent. As the majority correctly concluded, "'[*Chenery*] does not oblige the agency to provide exhaustive, contemporaneous legal arguments to preemptively defend its action.'" Op. 33 (quoting *Nat'l*

*Elec. Mfrs. Ass'n v. U.S. Dept. of Energy*, 654 F.3d 496, 515 (4th Cir. 2011)).

The majority also correctly rejected Altera's argument that "Treasury did not adequately support its position that employee stock compensation is a cost" (Op. 33-34). As the majority observed (*id.* at 34), whether the issuance of stock compensation gives rise to a "cost" under economic theory may be "debatable," but whether it gives rise to an accounting cost – including a tax accounting cost, *see* I.R.C. §§ 83(h), 162(a); Treas. Reg. § 1.83-7(a) (1978) – is not. *See* Reply Br. 41 ("Because our federal tax system is concerned with measuring results from operations, it necessarily relies on accounting-based information. And from an accounting perspective, stock-based compensation expense is a cost."); Gov't Br. 68 (noting the 2002 preamble's reference to the fact that since October 1995, the Financial Accounting Standards Board has recognized that stock-based compensation expense is a cost, and asserting that such recognition "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"). Given the seemingly straightforward resolution of this issue, we concur in the majority's

observation (Op. 35) that "the dispute here is not truly whether stock-based compensation is a cost but whether Altera – rather than the Commissioner – may decide how to apportion that cost between related entities."

Finally, the majority correctly rejected Altera's argument that "the [2003] cost-sharing amendments present a major shift in administrative policy" and that they are therefore subject to "more searching review" (Op. 35) under *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009). According to Altera, the shift in policy is the Commissioner's "'assertion that the commensurate with income clause [of § 482] supplants the arm's-length standard.'" Op. 35 (alteration added) (quoting Altera Br. 47). As we pointed out in our reply brief, however, "the 2003 preamble expressly refers to cost-sharing arrangements that are 'consistent with the commensurate with income standard, *and therefore consistent with the arm's length standard*.'" Reply Br. 30 (quoting T.D. 9088, 2003-2 C.B. 841, 842) (emphasis added). In other words (*id.* at 30-31), "Altera may disagree with Treasury's determination" in that regard, "but it cannot seriously claim that…Treasury took the position that the commensurate-with-income

requirement supplants the arm's-length standard." Thus, the majority correctly recognized (Op. 36) that Altera's argument on this point "is not meaningfully different from [its] general APA argument," *viz.*, "that Treasury misinterpreted § 482" (*id.* at 32). Moreover, any policy change – in the sense of a movement away from the "traditional" application of the arm's-length standard to the broader, results-oriented approach, *see supra* p. 24 – occurred "well before 2003" and was "a result of the 1986 amendment to § 482." Op. 37; *see* Reply Br. 31-33.

## III. The dissenting opinion conflates comparability analysis and the arm's-length standard

The dissent in the withdrawn opinion in this appeal suffers from the same infirmity that plagues Altera's original brief: it repeatedly conflates comparability analysis and the arm's-length standard (or arm's length "analysis"). *See* Op. 46 (referring to Treasury's "longstanding practice of applying the arm's length standard [presumably meaning "comparability analysis"] in all but the narrowest of circumstances"); *id.* at 47 (same); *id.* at 51 (erroneously stating that the Commissioner "argued on appeal [in *Xilinx*] that Treas. Reg. § 1.482-7 superseded the arm's length requirement of Treas. Reg. § 1.482-1"); *id.* at 53 (stating that "what Treasury was *actually* saying is

that § 482 no longer requires an arm's length analysis"); *id*. at 59 (stating that "Treasury may well have believed that…it could dispense with arm's length analysis entirely"); *id*. at 60 (stating that "Treasury never said…that the nature of stock compensation in the QCSA context rendered arm's length analysis irrelevant"); *id*. at 62 (stating that Treasury should have "set forth when and why the agency believed that arm's length analysis was not required"). As the majority correctly recognized (Op. 40), the 2003 cost-sharing amendments dispense with comparability analysis, *not* the arm's-length standard, in applying the commensurate-with-income requirement of § 482 to cost-sharing arrangements.

The dissent in this regard misconstrues (Op. 46) the majority's reference to "the traditional arm's length standard" (*id*. at 31) as referring to "the arm's-length standard" rather than the traditional *approach* to the arm's-length standard, an approach that relies on comparability analysis. *See supra* p. 10; Gov't Br. 10, 71; *see also* Op. 7 (accurately stating that "[a] traditional arm's length *analysis* looks to comparable transactions") (emphasis added). By essentially using the distinct concepts "arm's length standard" and "traditional arm's length

analysis" (read "comparability analysis") interchangeably, the dissent found a *Chenery* violation where there is none:

> In promulgating the rule we consider here, Treasury repeatedly insisted that it was applying the *traditional arm's length standard* and that the resulting rule was consistent with that standard. Today, however, the majority holds that Treasury's citation to the legislative history surrounding the enactment of the Tax Reform Act of 1986 "communicated its understanding that Congress had called upon it to move away from the *[traditional[5]] arm's length standard*." Op. 31.
> …

Op. 46 (emphasis and alteration added). To the contrary, Treasury never "insisted that it was applying the *traditional* arm's length standard" (*id.*); rather, it insisted that it was applying the arm's-length standard. And, in noting that Treasury "communicated its understanding that Congress had called upon it to move away from the traditional arm's length standard" (Op. 31), the majority did not suggest that Treasury had explicated its understanding that Congress had directed it to move away from the arm's length standard; rather, it recognized that Treasury imparted its understanding that Congress had

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[5] The dissent actually uses the word "historical" here, but the statement quoted from the majority opinion (Op. 31) uses the word "traditional."

directed it to move away from the traditional analysis under the arm's-length standard (*i.e.*, comparability analysis).

This misapprehension of the Commissioner's position (and of the majority's approval thereof) supplies the basis for the dissent's conclusion (Op. 47) that "Treasury's explanation of its rule did not satisfy the *State Farm* standard": according to the dissent (*id.*), Treasury "did not provide adequate notice of its intent to change its longstanding practice of employing the arm's length standard." Because Treasury in issuing the 2003 cost-sharing amendments had no intention of abandoning the arm's-length standard (which "applie[s] in every case," Treas. Reg. § 1.482-1(b)(1) (1994)), there can be no fair-notice violation of the type described by the dissent.

Moreover, the dissent's subsequent statement that Treasury "fail[ed] to put the relevant public on notice of its intention to depart from *traditional arm's-length analysis*," Op. 61 (emphasis added), *i.e.*, comparability analysis, cannot be squared with the language of the coordinating amendments themselves. Specifically, the amendment to § 1.482-7(a), which provided that a QCSA produces an arm's-length result if, and only if, it incorporates the cost/benefit sharing ratio,

necessarily presupposes an interpretation of § 482 as permitting Treasury to dispense with comparability analysis in this context. *See Nat'l R.R. Passenger Corp. v. Boston & Maine Corp.*, 503 U.S. 407, 419-420 (1992) (holding that "the only reasonable reading of the [ICC's] opinion…is that the ICC's decision was based on the proffered interpretation"); *Nat'l Elec. Mfrs.*, 654 F.3d at 513 (citing *Boston & Maine* for the proposition that "deference is appropriate…when the agency's litigation papers merely set forth an interpretation that was a 'necessary presupposition' of its underlying action"); *see also* Reply Br. 25-26.

Finally, turning to the issue whether the 2003 cost-sharing amendments represent a permissible construction of § 482 (the *Chevron* step-two analysis), the dissent concludes (Op. 63) that they do not: "Under the only reasonable interpretation of § 482,…the commensurate with income standard does not apply to QCSAs." The dissent notes (*id.*) that the statute refers to a "'transfer (or license) of intangible property,'" which, in its view, is materially "distinct from a cost sharing agreement." As explained in our reply brief at pp. 17-19, however, that is *not* the only reasonable interpretation of the term "transfer" here.

*See, e.g., Xilinx v. Commissioner*, 125 T.C. 37, 52 (2005) (recognizing that "[f]or purposes of section 482, this relinquishment [of "exclusive ownership of all exploitation rights"] constitutes a transfer of specified future exploitation rights"), *aff'd without addressing this issue*, 598 F.3d 1191 (9th Cir. 2010). And because this language is susceptible of more than one reasonable interpretation in this context, it is entirely appropriate to consult the relevant legislative history to determine Congress's intent. As discussed above, that history conclusively establishes that Congress expected Treasury to issue regulations applying the commensurate-with-income requirement to cost-sharing arrangements. *See* H.R. Conf. Rep. No. 99-841, at II-638 (referring to the basic economic terms a cost-sharing arrangement must contain "to produce results consistent with the changes made by the Act to royalty arrangements").[6]

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[6] The dissent also apparently believes that this Court's decision in *Xilinx* controls the outcome of this case. Op. 47; *but cf. id.* at 62. For the reasons stated by the majority (*id.* at 44-46) and in our reply brief at pp. 39-40, the dissent is wrong on this point. *See supra* pp. 21-22.

## CONCLUSION

For the foregoing reasons, and for the reasons discussed in our opening and reply briefs, 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.

*    *    *    *    *

## CERTIFICATE OF COMPLIANCE

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

Case Nos. 16-70496, 16-70497

1. This brief complies with the Court's order dated August 27, 2018 and the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because:

[X] this brief contains 6,499 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii), *or*

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(s) /s/ Arthur T. Catterall

Attorney for the Commissioner

Dated: September 28, 2018

## 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 September 28, 2018.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

/s/ Arthur T. Catterall
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