U.S. Department of Justice

Tax Division

Please reply to: Appellate Section
P.O. Box 502
Washington, D.C. 20044

Facsimile No. (202) 514-8456
Telephone No.(202) 514-3361

REZ:TAG:GSR:RF:ATCatterall
5-24255
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October 22, 2018

Molly C. Dwyer, Esquire
Clerk, U.S. Court of Appeals
for the Ninth Circuit
95 Seventh Street
San Francisco, CA 94103

Re: Altera Corp. & Subs. v. Commissioner of Internal Revenue
(9th Cir. – Nos. 16-70496, 16-70497)
<u>(Argued Oct. 16, 2018 – Thomas, C.J., and Graber and O'Malley, JJ.)</u>

Dear Ms. Dwyer:

This letter responds to Altera's letter to the Court dated October 19, 2018, regarding the October 16 hearing in these consolidated appeals.

Altera takes issue with our statement at the hearing that "nobody's arguing" that "evidence of third-party behavior could override" the periodic-adjustment rule that the 1986 House Report envisioned as a manifestation of the commensurate-with-income requirement, contending that it made that argument in its briefs. (Letter 1.) Altera's briefs, however, merely indicate that the regulation implementing the periodic-adjustment rule provides limited exceptions (see below). The point we were making at the hearing is that nobody – not even Altera (we think) – interprets the overarching arm's-length standard in a manner that renders the periodic-adjustment rule categorically subject to taxpayer veto through evidence of third-party behavior. If that indeed is Altera's position – a position that would make the statutory commensurate-with-income requirement altogether meaningless – then we stand corrected.

Altera then refers to the aforementioned regulatory exceptions to the periodic-adjustment rule in taking issue with our statement that the commensurate-with-income requirement does not require Treasury "to allow

taxpayers to override its terms by resort to evidence of third-party behavior." (Letter 1.) As we indicated in our reply brief, that Treasury provided limited relief from the periodic-adjustment rule does not mean that it was statutorily *required* to do so. Reply Br. 35 n.10 (second sentence). And it is worth noting that, consistent with legislative intent, the regulatory exceptions generally apply only if the licensee's actual profits from exploiting the intangible are within 20% of projected profits. Treas. Reg. § 1.482-4(f)(2)(ii)(B)(6), (C)(4); *see* H.R. Rep. No. 99-426, at 426 (1985) ("The bill is not intended to require annual adjustments when there are only minor variations in revenues.").[1]

Altera likewise cites one of the regulatory exceptions in taking issue with our statement that the periodic-adjustment rule "does not reflect what parties do in the real world." (Letter 1.) According to Altera, because one of the conditions to the exception is the existence of a comparable uncontrolled transaction that does *not* provide for periodic adjustments, it follows that there must be comparable uncontrolled transactions that *do* provide for periodic adjustments.[2] Putting aside the dubious nature of that reasoning, the relevant point is that our statement is entirely consistent with the sources we cited indicating that, by and large, license agreements between unrelated parties do not provide for periodic adjustments to the royalty to reflect the licensee's actual profit experience. *See* Gov't Br. 54-55, Reply Br. 10, 14. Indeed, at the first hearing in these appeals, Altera itself conceded that such periodic-adjustment provisions are "not super-common." 2017 Oral Arg. Video 25:27.

Thus, contrary to Altera's assertion, our statements at the hearing last week do not contradict any Treasury regulations, nor do they somehow

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[1] Altera also cites Treas. Reg. § 1.482-4(f)(2)(ii)(A), but that exception only applies where the taxpayer can point to a comparable uncontrolled transaction involving *the same intangible*.

[2] Altera also quotes Notice 88-123, 1988 C.B. 458, 480, for the proposition that "unrelated parties generally provide some mechanism to adjust for change in the profitability of transferred intangibles." (Letter 1-2.) The Notice was referring to provisions that allow the parties to terminate the existing agreement and open it up to renegotiation, not mandatory adjustment provisions. *See id.* at 526-527.

implicate *Chenery*, *State Farm*, or *Fox Television*.[3] We agree with Altera, however, that the Court's procedural focus in these appeals should be on the "agency's on-the-record justifications for its actions" (Letter 2) – here, Treasury's undeniable and repeated reference to its determination that it was implementing legislative intent as reflected in the 1986 Conference Report.

Kindly distribute this letter to the members of the panel assigned to these appeals.

Respectfully submitted,

RICHARD E. ZUCKERMAN
Principal Deputy Assistant Attorney General

TRAVIS A. GREAVES
Deputy Assistant Attorney General

/s/ Arthur T. Catterall

GILBERT S. ROTHENBERG (202) 514-3361
RICHARD FARBER (202) 514-2959
ARTHUR T. CATTERALL (202) 514-2937
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

[3] While the 2003 cost-sharing amendments dispense with comparability analysis – what Altera refers to as "arm's-length evidence" (Letter 2) – in this narrow context, they do not "abandon[ ]…the parity principle" (*id*.). *See* Reply Br. 6 n.1, 39.

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/s/ Arthur T. Catterall
ARTHUR T. CATTERALL
Attorney for the Commissioner