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Daily Tax Report®

INSIGHT: Altera v. Commissioner—Administrative Procedure Act Under Siege?

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The Ninth Circuit recently overruled the U.S. Tax Court on a significant question regarding the validity of Treasury's final cost-sharing regulations governing stock-based compensation.

The Tax Court had previously ruled in a 15-0 decision that the promulgation of these regulations violated the Administrative Procedure Act (the APA) which is codified at 5 U.S.C. Sections 701-706. The Tax Court decision can be found at 145 T.C. 91 (2015).

Two appellate judges embraced the government's view that Treasury had met the requirements of the APA. The dissenting judge found just the opposite and agreed with the Tax Court. The majority, in a signal that it had little concern with the APA issue, took up a secondary analysis under *Chevron* first. By doing so it created rhetorical momentum to discard the Tax Court's analysis and the taxpayer's own APA-based arguments. Altera has recently petitioned for a rehearing *en banc* in part on the grounds that the majority decision ''turns the APA on its head.''

Background—Promulgation and Tax Court Decision

Relying upon its general rulemaking authority and tax code Section 482, Treasury issued the contested regulations in proposed form in 2002. In the notice of proposed rulemaking (NPRM), 67 Fed. Reg. 48997, Treasury stated its intention to clarify the existing cost-sharing regulations to include stock-based compensation as a cost to be shared and to provide a method for valuing such costs. It requested comments ''on the clarity of the proposed regulations and how they may be made easier to understand.'' 67 Fed. Reg at 49001.

The question whether stock-based compensation costs must be shared in the first instance was not up for discussion. Nonetheless, some parties submitted substantial written comments on this question. Those comments supported the proposition that uncontrolled parties do not share stock-based compensation costs on two general grounds: (i) that there was no evidence uncontrolled parties shared these costs and (ii) that such parties would not share these costs. Despite the comments, Treasury issued final regulations that generally adopted the proposed regulations by defining stock-based compensation costs as costs to be shared between controlled parties and by providing valuation methods for such costs.

Treasury did address these comments in the preamble to the final regulations. However, it was the nature of Treasury's response which the Tax Court unanimously judged to be a critical defect. The court turned to the record of comments to show that Treasury had no evidence for its position and, moreover, that it had dismissed out of hand substantial evidence which showed that parties acting at arm's-length would not share these types of costs. For the Tax Court this meant that Treasury had not satisfied the ''reasoned decision making standard'' which is imposed, through judicial interpretation, by the APA.

What Comes First?

In the Ninth Circuit, the majority first considered whether the regulations were valid under *Chevron*. However, the Tax Court based its holding on the application of the APA, not *Chevron*. *Chevron* requires a substantive review of the statute and rule at issue by first instructing courts to consider whether a statute provides the answer and, if not, second, whether the agency's rule reasonably implements the statutory purpose. The Tax Court held that the agency did not satisfy the rule-making process required by the APA and thus never directly discussed the merits of the regulations under *Chevron*. Indeed, the majority itself cites to *Catskill Mountains Chapter of Trout Unlimited, Inc. v. EPA*, 846 F.3d 492 (2d Cir. 2017) for the proposition that a rule will be set aside under the APA ''regardless of whether its interpretation of the statute is reasonable.'' Slip op. at 33. *Cf. Azar v. Allina Health Services*, Docket No. 17-1484 (Sup. Ct., June 2, 2019) (invalidating HHS Medicare rule on the grounds that the agency violated the notice and comment procedure mandated by a Medicare-specific version of the APA).

Chevron

Under its *Chevron* analysis, the majority determined that the authorizing statute, Section 482, did not speak to the issue whether cost-sharing arrangements must include stock-based compensation costs. This is an uncontroversial proposition as the statute does not address cost-sharing at all, much less methods by which to share costs or what types of costs ought to be shared between controlled parties. The majority then considered what was proposed by the Government as the core statutory language underlying the final regulations: ''In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be

commensurate with the income attributable to the intangible.'' Section 482.

In the view of the majority, Congress's use of the phrase ''any transfer'' included even future contingent transfers of intangibles such as those the majority asserted were imbedded in all cost- sharing arrangements. Slip op. at 26. The problem faced by the majority was that controlled parties agree to share costs incurred in the development of intangibles that are *already* transferred via a license or other transfer agreement. The majority's broad construction of the term transfer is a dubious stretch. The parties to a cost-sharing arrangement already have co-ownership of the transferred intangibles and no transfer of those intangibles *as developed* is therefore needed. Even if new intangibles arise through joint development efforts, as noted by the dissent, these were not transferred at the time the cost-sharing agreement was entered into because they did not exist, and are not later transferred from one party to another because they arise and are owned by both parties *ab initio* when developed. Slip op. at 78. Nevertheless, despite the logical flaw in its reasoning, the majority concluded that the statute generally authorized Treasury to regulate cost-sharing agreements through the commensurate-with-income statutory mandate.

The remaining question was whether the final regulations were a reasonable implementation of the statute. The majority answered in the affirmative. In short, the majority viewed Congress as authorizing an approach to valuation of intangible transfers (and associated cost-sharing arrangements) divorced from arm's-length data. In articulating this view the majority showed a schizophrenia about the purpose of Section 482. The majority acknowledged that Section 482's general goal is to create tax parity but, on one hand, cites Treasury's understanding of tax parity as between controlled and uncontrolled taxpayers (slip op. at 16), and on the other suggested that uncontrolled taxpayers are irrelevant. In any event, once the majority had determined that by the introduction of the commensurate-with-income standard Congress had directed Treasury to value intangible transfers without reference to arm's-length data, the answer of ''yes'' to the second *Chevron* question followed easily.

The Majority's Disregard of the APA

The majority's approach to the order of analysis was not just cosmetic; other decisional paths it took showed its blithe disregard for the requirements of the APA.

First, in the Tax Court, the taxpayer showed that U.S. tax treaties with other nations relied upon the arm's-length standard as the fundamental measure of an appropriate transfer price. Here, the majority pointed to an unratified tax treaty between the U.S. and Poland which incorporated by reference the final regulations. The majority concluded therefore that the final regulations were not inconsistent with the most recent tax treaties.

Putting aside whether an unratified treaty has any legal importance at all, the requirements imposed by the APA pertain to the regulation *at the time it was promulgated*. Evidence of what happened post-promulgation is not relevant to the inquiry whether Treasury complied with the APA in the issuance of the regulations. Indeed, suppose Treasury in 2018 had re-promulgated the same regulations and, *ex arguendo*, satisfied all APA requirements. Such a promulgation would not thereby rehabilitate any APA defects in the 2003 regulations.

Admittedly the majority made this observation in the course of its *Chevron* analysis; however, its silence on the status of treaties at the time of promulgation of the final regulations bespeaks the same disregard of the APA. In other words, that our treaties incorporated the arm's-length standard as the fundamental rule of transfer pricing at the time of promulgation of the final cost-sharing rules was a fact that *for APA purposes* could not be disregarded in evaluating the decision of the Treasury to effectively jettison such standard.

Second, the majority did not consider the Tax Court's valid critique of the overbroad nature of the final rule. There is little debate that Congress intended the commensurate-with-income standard to apply to transfers of high-profit potential intangibles. This was in fact an integral part of the majority's interpretation of the legislation history, to wit, that Congress recognized the sometimes difficult task in identifying comparables for such transfers and so created the commensurate-with-income standard. The final rule, however, applies to all cost-sharing agreements regardless of the underlying property which had been transferred to the related party. How can the final rule then be valid under the APA if it exceeds the statutory mandate in this regard? *See* 5 U.S.C Section 706(2)(C).

Third, the majority erroneously accepted the Government's post hoc rationalization of the final regulations. The preamble to the final rule is the agency's opportunity to state, in accordance with requirements of the APA, the basis for the rule. Treasury did not claim authority to issue the final rule based on the commensurate-with-income standard other than as an application of the arm's-length standard:

''After fully considering these comments [including primarily those which provided evidence that parties at arm's-length do not share such costs], Treasury and the IRS continue to believe that the proposed regulations reflect a sound application of established principles under section 482.''

. . .

''Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QSCAs is consistent with the legislative intent underlying section 482 and with the arm's-length standard. . . . 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.'' Treasury Decision No. 9088, Preamble.

One of those established principles could be fairly described as the fundamental rule of transfer pricing: Treas. Reg. § 1.482-1(b)(1), which provides that ''[i]n 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.'' Thus where the Government, in arguing before the Tax Court, attempted to de-link the commensurate-with-income standard from the arm's-length principle and propose such standard as a separate basis for the final rule, the Tax Court rejected this attempt, not on substantive (or *Chevron*) grounds but on APA grounds, noting that ''[a]lthough Treasury referred to the commensurate-with-income standard in the preamble to the final rule, it relied on its belief that

the final rule was required by—or was at least consistent with—the arm's-length standard.'' 145 T.C. at 121.

That court then concluded: ''Moreover, because Treasury did not rely exclusively on the commensurate-with-income standard, we cannot sustain the final rule solely on that basis if we decide that Treasury's reliance on the arm's-length standard in issuing the final rule was unreasonable.'' *Id.* at 122. Thus, from an APA perspective, because Treasury's explanation of the final rule invoked the arm's-length standard to support the rule and simultaneously rejected evidence that showed the final rule was not consistent with the application of the arm's-length standard the Tax Court found Treasury had not engaged in reasoned decision-making.

The majority on appeal disagreed with the Tax Court's understanding of Treasury's rationale for the rule, and couched its analysis as if Treasury had applied the arm's-length standard through reference to the commensurate-with-income standard. But how can this be?

To view Treasury as imposing such a standard where the only available evidence showed no arm's-length parties sharing such costs is contrary to ''established rules'' that Treasury explicitly said it was applying. The Ninth Circuit's approach was to read between the lines of the regulatory record in such a way as not only to propose the commensurate-with-income standard as an independent ''internal method'' for reaching arm's-length results but to do so while rejecting what the public would have understood to be actual arm's-length data. Indeed, the regulatory file showed that Treasury not only did not seek any comments on arm's-length data, it made no independent attempt to collect arm's-length data regarding cost-sharing of stock-based compensation costs. The logical starting point for Treasury should have been, ''What is the evidence regarding cost-sharing of these costs?'' not ''we don't care whether there is evidence or not, should we modify our proposed methods to compute those costs?''

The Supreme Court recently decided an APA case which casts some doubt on the approach of the Ninth Circuit. In *Department of Commerce v. New York*, No. 18-966 (June 27, 2019), the issue was whether the Secretary of Commerce validly modified the decennial census questionnaire to include a question about citizenship. The majority decided that a given reason offered in the course of litigation for a change to the census form appeared to be a pretext and that the modification might have stemmed from undisclosed and possibly political motivations. The majority then concluded that the proposed modification could not be sustained on the record before it as part of a reasoned decision-making process: ''The reasoned explanation requirement of administrative law, after all, is meant to ensure that agencies offer genuine justifications for important decisions, reasons that can be scrutinized by courts and the interested public. Accepting contrived reasons would defeat the purpose of enterprise.'' *Department of Commerce,* slip op. at 28. How much more suspect then is an agency action which *a priori* determines that evidence relating to a fundamental rule of transfer pricing is irrelevant?

Rehearing?

The importance of the legal question of the application of the APA and the economic importance of the issue together provide a sound and judicially prudent predicate for rehearing. Moreover, given the tension of the majority's decision with *Xilinx*, which Altera has correctly described as raising an intra-circuit conflict, the Ninth Circuit should closely consider Altera's petition. Under Ninth Circuit rules we should know in the next month or two whether Altera has the opportunity to argue before the court *en banc*.

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