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KPMG report: Ninth Circuit reverses Tax Court (again), upholds cost-sharing regulations

The U.S. Court of Appeals for the Ninth Circuit late last week issued a new opinion reversing a 2015 decision of the U.S. Tax Court that had invalidated a Treasury regulation under section 482 (Reg. § 1.482-7A(d)(2), or the "regulation") that requires participants in a qualified cost-sharing arrangement (QCSA) to share the cost of employee stock-based compensation.

The new Ninth Circuit's decision considers what is required by the "arm's length standard," which has developed as the benchmark for transfer pricing in Treasury regulations and treaties but is notably absent from the statute. Ultimately, the Ninth Circuit held that an arm's length result may be achieved using a "fluid" set of methodologies, and does not require a "transactional comparability analysis." The new opinion also considered what constitutes a transfer of intangibles, holding that a QCSA "transfer[s] future distribution rights to intangibles."

The Ninth Circuit concluded that the regulations "withstand scrutiny" and thus reversed the Tax Court.

The case is: *Altera Corp. v. Commissioner*, Nos. 16-70496, 16-70497 (9th Cir. 7 June 2019). Read the **Ninth Circuit's decision**, which includes a dissenting opinion.

Background

In July 2018, the Ninth Circuit issued a substantially similar opinion, reversing the Tax Court and upholding the regulation in a 2-1 decision written by Judge Thomas, with Judge Reinhardt concurring and Judge O'Malley dissenting. The Ninth Circuit issued the earlier opinion even though Judge Reinhardt had died almost four months earlier, noting that "Judge Reinhardt fully participated in this case and formally concurred in the majority opinion prior to his death." Nonetheless, the Ninth Circuit withdrew the decision two months later and added Judge Graber to the panel. The case was reargued in October 2018.

The Tax Court in a "reviewed opinion" (there were no dissenting opinions) had invalidated the 2003 regulation. Based on information indicating that unrelated parties do not share stock-based compensation costs, which was submitted in comments as part of the rule-making process, the Tax Court concluded that Treasury's position that the final regulations were consistent with the arm's

length standard was contrary to all of the evidence and lacked a "basis in fact." The Tax Court further held that Treasury had "failed to respond to significant comments" when issuing the final regulation and that the final regulation failed to satisfy the U.S. Supreme Court's "reasoned decision-making" standard in *State Farm*.

On appeal before the Ninth Circuit, the taxpayer maintained that the arm's length standard always demands a comparability analysis, meaning that the IRS cannot allocate costs between related parties in the absence of evidence that unrelated parties would share the same costs when dealing at arm's length. The taxpayer contended that, because uncontrolled taxpayers do not share the cost of employee stock options, the IRS cannot require related parties to share that cost.

The IRS countered that it may, consistent with the arm's length standard, apply a purely internal method of allocation, distributing the costs of employee stock options in proportion to the income enjoyed by each controlled taxpayer. In the IRS's view, the commensurate-with-income method is consistent with the arm's length standard because controlled cost-sharing arrangements have no equivalent in uncontrolled arrangements, and Congress had provided that the IRS may dispense with a comparability analysis when comparable transactions do not exist in order to achieve an arm's length result.

Ninth Circuit decision

The Ninth Circuit's new decision, like the 2018 decision, reversed the Tax Court and upheld the regulation in a 2-1 decision, with Judge Thomas writing for the majority, Judge Graber concurring, and Judge O'Malley dissenting.

The new decision largely functions as an expanded version of the 2018 opinion, borrowing not only its holding but also much of its language. Both decisions held that the regulation withstands scrutiny, was not arbitrary and capricious, and was a reasonable execution of the authority delegated by Congress to Treasury. Accordingly, both opinions concluded that "[section 482] allows Treasury to apply a purely internal method of allocation, distributing the costs of employee stock options in proportion to the income enjoyed by each related taxpayer."

The new decision, however, departs from the 2018 opinion in its focus and analysis. Noting that the taxpayer argued that the IRS must employ "a comparability analysis using comparable transactions between unrelated business entities," and that Treasury disagreed, the new opinion clarifies that the ultimate question in the case is: What methods may be used to apply the arm's length standard? Whereas the 2018 opinion characterized the approach of the regulations at issue as a departure from the "traditional arm's length standard," the new opinion (armed with the Commissioner's supplemental brief upon rehearing) points to legislative and regulatory history, as well as case law, indicating that "for most of the twentieth century the arm's length standard explicitly permitted the use of flexible methodology in order to achieve an arm's length *result*" (emphasis in original).

In multiple places, the new opinion notes that the purpose of section 482, and the importance of achieving an arm's length result, is to prevent tax evasion by related business entities and achieve "tax parity" between controlled and uncontrolled taxpayers. Accordingly, the new opinion finds that the arm's length standard is "not confined to one methodology," as reliance on a single method "reflects neither how related parties behave nor how they are taxed." Based on the "long history" of the application of multiple methods, the new opinion concludes that it was reasonable for Treasury to "move away from" the view that a comparability analysis is required to achieve an arm's length result, as Congress and Treasury had been doing since "the Tax Reform Act of 1984 and 1994 and 1995 implementing regulations."

Prompted by a new argument by the taxpayer on rehearing, the new decision also considers whether stock-based compensation costs are associated with a "transfer" of intangibles under a QCSA, thereby invoking the second sentence in section 482 governing the transfer or license of intangibles. The

taxpayer seems to have argued that future intangibles are not transferred under a QCSA, but rather mutually developed, so that there is no transfer of intangibles with which to associate stock-based compensation costs. The new opinion rejects this argument, insisting that a QCSA "transfer[s] future distribution rights to intangibles" and that "the present-day transfer of those rights provides the main incentive for entering into a QCSA."

In an expanded dissenting opinion (twice the length of the 2018 dissent), Judge O'Malley stated, as she did in 2018, that she would have invalidated the regulation and affirmed the Tax Court decision. Opining that the regulation is "procedurally and substantively defective," Judge O'Malley chastised the majority for accepting "the Commissioner's ever-evolving post-hoc rationalizations."

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