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United States

'Altera' Decision Calls Into Question Meaning of 'Arm's-Length' in Cost Sharing

The U.S. Tax Court's July 27 ruling in *Altera Corp. v. Commissioner* could have implications that go far beyond the immediate issue in the case, forcing radical changes in Treasury's rulemaking process and—some practitioners say—raising fundamental questions about the utility of the arm's-length standard.

The ruling on cross-motions for partial summary judgment, which strikes down 2003 regulations (T.D. 9088) as invalid under the Administrative Procedures Act, chastised the Internal Revenue Service and Treasury for failing to take into account or address the extensive commentary of taxpayers opposed to the rule. The court found that Treasury's conclusion that the rule was consistent with the arm's-length standard was not supported by any evidence, but rather "epitomizes arbitrary and capricious decisionmaking."

Practitioners contacted by Bloomberg BNA said the opinion makes clear that the IRS is subject to the same kind of rulemaking requirements as any other agency. But because Treasury has long taken the opposite position—that the Administrative Procedures Act does not apply to it—it also means a host of other Treasury regulations, including the entire cost sharing regime itself, could be at risk.

David Varley, acting director of transfer pricing with the Large Business & International division of IRS, said July 30 the ruling comes as a personal disappointment but that it is too early to comment on behalf of the IRS.

"We need to look at it and how it will affect other cases," Varley said during a webcast sponsored by EY LLP. "And then we will be in consultation" with Associate Chief Counsel International "and other counsel about the next steps."

Clear Consequence. Patrick J. Smith of Ivins, Philips & Barker in Washington, D.C., told Bloomberg BNA that "the one clear consequence is that we'll be seeing a lot more challenges under the arbitrary and capricious standard. People are going to start looking around at regulations they don't like, and asking themselves, 'Did the IRS make similar failures in issuing those other regulations?' The answer is going to be 'yes.' "

Steven Hannes of McDermott Will & Emery LLP in Washington agreed.

"The IRS has a tough decision to make because there are other parts of the regulations that are not at issue here that some taxpayers would say share the same fault—other requirements that are theory-based, not empirically based, and inconsistent with the arm's-length standard," he said. "And reading this opinion broadly, there is a good chance this court would hold them to be invalid."

J. Richard Harvey Jr., a professor of law with Villanova School of Law, told Bloomberg BNA that "some taxpayers that have taken non-transfer pricing positions contrary to IRS regulations will be reviewing the case to determine whether they have another weapon in their defense arsenal."

At the same time, Harvey said, "I would expect corporations to be reevaluating their FIN 48 tax reserves and possibly releasing some tax reserves to the extent they took tax return positions contrary to the cost sharing regulations."

Further, he said, "one has to assume the Tax Court's decision will be appealed, and therefore some taxpayers may hold off adjusting their reserves until the appellate decision is made."

Mark Nebergall, president of the Software Finance and Tax Executives Council, told Bloomberg BNA an IRS appeal of the decision might create further difficulty for taxpayers that have been waiting for a resolution of *Altera* to make decisions about their own costs.

"My initial reaction is, is the IRS going to keep digging? Will they appeal, will they try to do another reg

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project? There's a lot of cases in the pipeline. My concern is that they will continue to remain in limbo if the government appeals.''

If the IRS does appeal, it will have an uphill battle, according to Hannes, because the forum will be the U.S. Court of Appeals for the Ninth Circuit—the same court that shot down the agency on the same issue in *Xilinx Inc. v. Commissioner*.

But if the IRS doesn't appeal and doesn't revisit the regulations, Hannes said, the agency ''stands a high risk of being whipsawed'' by taxpayers taking opposing positions—those companies that want to take into account stock-based compensation costs and those that don't.

Until the agency revises or withdraws the cost-sharing regulations, it is valid and taxpayers that benefit from taking stock-based compensation costs into account can continue to do so. And those that don't want to share the costs now have a powerful Tax Court opinion that supports that position, he said.

''There are two ways to resolve that inconsistency,'' Hannes said. ''The IRS could file an appeal and win—but that may take years, and based on the record before us, that is a real uphill battle for the IRS. Alternatively they could see the error of their ways, acquiesce to the decision and change'' the stock options aspects of the regulations.

Challenge to 2003 Regulations. Altera Corp. is a California-based manufacturer of programmable semiconductors and related products, with $1.8 billion in sales worldwide. The case consolidates two separate deficiency notices and involves $97 million in adjustments to income for years 2004-07 arising from a cost-sharing arrangement between the U.S. parent and a Cayman Islands affiliate. The bulk of the adjustment—$80 million—is related to stock-based compensation granted to specific employees engaged in research and development activities.

In disputing the adjustments, Altera challenged the validity of T.D. 9088 that specifically required stock options to be included in the pool of costs under cost-sharing arrangements. Altera argued that the IRS violated the Administrative Procedures Act when it adopted that provision over the objections of multiple stakeholders, who pointed out in extensive comments that there was no evidence unrelated parties share stock option costs.

The court agreed that Treasury violated the Administrative Procedures Act in its failure to address stakeholder comments or explain its rationale.

''It was not just, or even mainly, the lack of an explanation that the court found to be defective,'' Smith said. ''It was the basic reasoning process that the IRS used that was defective. The court clearly said that the arm's-length standard under Section 482 requires an empirical analysis, in order to decide what the right answer is. The IRS did not undertake that kind of analysis. They said, 'We can just think in our offices about what the right answer should be, and we don't have to consider whether that's what people would do in the real world.' ''

He added: ''The tax court said that whole approach is flawed. It's not merely procedural. It's much more fundamental than that. The whole thought process that the IRS has applied was wrong, basically. The court said this is not the way to go about deciding what the right answer should be, under Section 482. That's really a very serious flaw in the IRS's approach in this case.''

Rehash of 'Xilinx'. The opinion is especially defeating for the IRS because the 2003 regulations were intended to cure a defect that led to the agency's loss in *Xilinx*. In *Xilinx Inc. v. Commissioner*—ultimately upheld by the Ninth Circuit—the Tax Court looked to evidence of third-party transactions submitted by Xilinx Inc. to determine that the company need not share stock option costs under its joint venture with an Irish affiliate.

Xilinx dealt with the 1995 regulations, which stated that ''all costs'' must be shared by the parties to a cost-sharing arrangement, but didn't explicitly identify stock-based compensation as one of those shared costs. The 2003 regulations were intended to correct that omission.

David Rosenbloom of Caplin & Drysdale in Washington, D.C., questioned how Treasury's approach to rulemaking will change in light of *Altera*.

''I do not believe the court's approach to the case, with extensive analysis of APA principles and invocation of Supreme Court precedents involving regulations issued by other federal agencies, has much, if any, precedent in the tax area,'' Rosenbloom said in an e-mail.

''The Internal Revenue Service (and Treasury) are indisputably federal agencies, but the review of Treasury regulations has for decades proceeded along its own, pretty isolated, path. I wonder what the outcome will be if the court's approach in *Altera* is applied to other Treasury regulations, beyond those relating to cost sharing and even completely beyond transfer pricing. That would usher in an entirely new process, and maybe new standards, of review.''

Implications for BEPS. John Henshall of Deloitte in London said the decision comes as no surprise given *Xilinx* and other decisions that point to the need to rely on evidence of what parties do at arm's length.

''What this means directly is that the IRS will not be able to force the inclusion of a proxy for the notional cost of stock-based remuneration into cost sharing and claim that is within the arms-length principle. If they want to take that route it will require legislation outside of the arms-length principle.''

In fact, he said, because of its emphasis on the necessity of evidence in resolving a dispute, the decision ''should be a wake-up call'' for every tax authority and for the Organization for Economic Cooperation and Development.

But there is another reason that other governments and the OECD should pay attention, he suggested.

''It does bring into question the approach of OECD Working Party 6, who are trying to make 'cost' sharing into something based on 'value' of contribution. In my 30 years, I have not yet come across a third-party cost share arrangement that looked at 'value' other than as a part of the buy-in process,'' he said.

Rosenbloom agreed that the opinion has implications for the OECD's project to combat base erosion and profit shifting.

''This court is very heavily influenced by *Xilinx*,'' he said. ''Yet you would have to say that the court is applying an unusual version of the arm's-length standard and it's applying it in a way that opens up the arm's-length standard beyond what we've seen in the past.''

Rosenbloom said the decision moves in the direction of applying the arm's-length standard to behavior as op-

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posed to price—an approach taken in some guidance under the OECD's BEPS project that has drawn sharp criticism from taxpayers.

''This decision could be read as supporting the kinds of things that the developing countries are trying to do with BEPS, which is to get away from strict 'arm's length' and look to where the value is really created.''

He added, ''That may not be bad, but I think if that's the way the law proceeds, it's going to be a two-edged sword. It's not always going to hurt the government; it's going to hurt taxpayers.''

The fundamental supposition of the opinion, he said, is that in order to establish that a transaction is at arm's length, one must show evidence that uncontrolled parties would engage in the same behaviors.

If that is the metric, however, then it can work in reverse: It would be possible to invalidate a related-party agreement on the ground that unrelated parties never engage in such a transaction.

''The entire arm's-length method is based on methodological approaches that unrelated parties don't use,'' he said. ''If unrelated parties are dealing with transactions between themselves, they're not looking for comparables; they price things based on what's in it for them.''

What Is Arm's Length? In that respect, the opinion lays bare the fundamental conundrum about the arm's-length principle that has dogged the IRS, the OECD and a host of other tax authorities for many years, according to Elizabeth King of Beecher Consulting in Brookline, Mass.

''The issue of what is or isn't consistent with the arm's-length standard and how do you interpret it in situations where related parties are doing things unrelated parties wouldn't is really the bugaboo here,'' she said.

There is no question that related parties transfer intangibles of a nature that unrelated parties do not, she said. What are often referred to as the ''crown jewels'' of a corporation—the high-value intangibles that are essential to its operation and profits, such as trademarks, copyrights, patents and other intellectual property—are often the focus of cost sharing arrangements.

The transactions are difficult to price through traditional methods that rely on the use of comparables—because for many of these transactions, there are no comparables.

''The issue has been on the table since the commensurate-with-income standard was introduced,'' King said.

Unrelated parties enter into research joint ventures, she said, but these agreements are not structured like related-party cost sharing agreements, in which the U.S. affiliate develops platform contributions for which the foreign affiliate offers compensation—frequently deemed by the IRS to be inadequate—and the debate is over the value of the transferred intangibles.

The arm's-length principle says that one must look to third-party transactions to arrive at a price for a related-party transaction.

''But the IRS takes the position that in certain areas—and cost-sharing is one of them—related parties don't act in the same way as unrelated parties. You can't look to third-party research joint ventures as a guide, because the types of cost sharing that related companies enter into are fundamentally different,'' King said.

Said Rosenbloom: ''I'm very skeptical that there are unrelated cost sharing agreements involving crown jewel intangibles, such as you have in *Xilinx* and *Altera*. You have agreements to do things but they are at the margins of the business.''

Qualitative Differences. In Altera, he said, the more critical point is that ''when you are dealing with two unrelated parties, it is just qualitatively different from a public company entering into a transaction with a wholly owned subsidiary.''

When related parties are involved, there is just one publicly traded stock, he said, ''and everybody involved in the transaction has a common interest in the value of that stock.'' When unrelated parties are involved, there are two publicly traded stocks and each company has a vital interest in the value of its own stock. The fact that unrelated parties don't share stock-based compensation ''does not prove squat,'' he said.

''Of course they're not going to share each other's stock-based compensation,'' he said. ''That involves taking a risk that goes way beyond whatever deal they have.''

The IRS, however, didn't make that argument effectively in either *Xilinx* or *Altera*, in part because it maintained that its cost sharing regulations are consistent with the arm's-length principle, while ignoring one of the fundamental tenets of arm's-length pricing—the activity of unrelated parties engaged in similar transactions.

The agency might make a more successful case by acknowledging that its regulations do not comport with the arm's-length principle, but that cost sharing is a special case. However, that would put the IRS and Treasury in an extremely difficult position, King said, because of the U.S.'s public stance in the BEPS project as an advocate for the arm's-length principle and against special measures.

Moreover, the arm's-length standard is hard-baked into every tax treaty the U.S. has.

''You can't depart from that comfortably,'' King said.

Underlying all of this is that Congress, through its 1986 amendment to Section 482 adopting the commensurate-with-income standard, has made clear that cost-sharing is a vehicle that should be available to U.S. multinationals. Yet there is no question that the IRS views cost-sharing much differently, as a vehicle for tax evasion, she said.

And so the agency has tried to discourage cost sharing through its regulations, King said, such as those requiring the income method of valuation, which converts cost-sharing arrangements into de facto licensing agreements.

''Maybe the answer is the arm's-length principle doesn't work all that well anymore,'' King said.

When most companies operated within national borders and global operations were fairly rare, the arm's-length principle was meant to ensure parity in tax treatment for affiliates of multinational corporations that were largely engaged in the manufacture and sale of tangible goods.

''It may be that the arm's-length standard was built for a different time,'' King said.

By Dolores W. Gregory and Alex M. Parker

To contact the reporter on this story: Dolores W. Gregory in Washington at dgregory@bna.com and Alex M. Parker in Washington at aparker@bna.com

To contact the editor responsible for this story: Molly Moses at mmoses@bna.com

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