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Brief of Amici Curiae J. Richard Harvey, Leandra Lederman, Ruth Mason, Susan Morse, Stephen Shay and Bret Wells in Altera Corp. v. Commissioner, in Support of Respondent-Appellant Commissioner

Citation
Brief for J. Richard Harvey, Leandra Lederman, Ruth Mason, Susan Morse, Stephen Shay & Bret Wells as Amici Curiae Supporting Respondent-Appellant, Altera Corp. v. Commissioner, (No. 16-70496 & No. 16-70497)(9th Cir. July 1, 2016).

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No. 16-70496 and No. 16-70497

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 DECISIONS OF
THE UNITED STATES TAX COURT

BRIEF OF AMICI CURIAE
J. RICHARD HARVEY, LEANDRA LEDERMAN, RUTH MASON,
SUSAN MORSE, STEPHEN SHAY AND BRET WELLS,
IN SUPPORT OF RESPONDENT-APPELLANT

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IDENTITY AND INTEREST OF AMICI

Amici are tax professors who conclude that the stock-based compensation cost sharing regulations at issue in this case are not arbitrary and capricious, but rather are a valid and reasonable exercise of the responsibility of the Treasury Department to administer Section 482 of the

Internal Revenue Code. Amici have no financial interest in the outcome of this case. The parties to this case have consented to the filing of this brief.

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STATEMENT OF AUTHORSHIP AND FUNDING OF BRIEF

No party's counsel authored any portion of this brief, in whole or in part. No person or entity other than amici has or is expected to contribute money intended to fund preparing or submitting this brief.

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TABLE OF ABBREVIATIONS

1986 Act – Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085

APA – Administrative Procedure Act, 5 U.S.C. § 551 et seq.

DOL – Department of Labor

FCC – Federal Communications Commission

Government Brief -- Brief for the Appellant, Altera Corporation v. Commissioner, Nos. 16-70496, 16-70497 (9th Cir. June 27, 2016)

IP – intellectual property

IRC – Internal Revenue Code, 26 U.S.C. § 1 et seq.

IRS – Internal Revenue Service

QCSA – qualified cost-sharing agreement

R&D – research and development

Section 482 – 26 U.S.C. § 482

Treas. Reg. – 26 C.F.R

SUMMARY OF ARGUMENT

The Tax Court invalidated a cost-sharing regulation under Section 482. That regulation, Treas. Reg. § 1.482-7(d)(2), conditions the validity of controlled taxpayers' income allocation under a cost-sharing agreement upon the requirement that the controlled parties share all costs, including stock-based compensation costs, proportionately with the benefits they expect to receive from joint development of intangibles.

While not disputing Treasury's broad mandate under Section 482, the Tax Court concluded that Treasury's cost-sharing regulation was arbitrary and capricious under Section 706(2)(A) of the APA because Treasury did not directly refute evidence submitted in the notice-and-comment period that uncontrolled parties did not share stock compensation costs. The Tax Court concluded that Treasury's "'explanation … [ran] counter to the evidence before it.'" *Altera Corp. v. Commissioner*, No. 6253-12, slip op. at 66 (T.C. July 27, 2015) (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43 (1983)).

We concur with the government's argument before this Court that coordinating amendments promulgated with Treas. Reg. § 1.482-7(d)(2) vitiate the Tax Court's analysis in *Xilinx* that the cost-sharing regulation conflicts with the arm's-length standard. *See* Brief for the Appellant, Altera

Corporation v. Commissioner, Nos. 16-70496, 16-70497 (9th Cir. June 27, 2016) (hereafter "Government Brief") at 44-48. Furthermore, we agree with the government's arguments that the "commensurate with the income" standard in the second sentence of Section 482 contemplates a purely internal approach to allocating income from intangibles to related parties. This internal approach requires no reference to uncontrolled transactions, and therefore it does not require consideration of any evidence of such uncontrolled transactions. That Congress intended a purely internal approach under the second sentence of Section 482 is clear from, among other things, the Conference Committee's reference to using costs as a proxy for each of the related parties' real economic contributions. Government Brief at 50-57. We also agree that Treasury's commensurate-with-income authority under the second sentence of Section 482 provides an independent basis for upholding the cost-sharing regulation, as we believe will be argued in an amicus brief submitted in this case by Anne Alstott et al. We therefore urge this Court to reverse the Tax Court.

The purpose of this amicus brief is to offer an alternative argument for the validity of the cost-sharing regulation under what the government in its brief called the "traditional" view of the arms' length standard, *see, e.g.*, Government Brief at 51, which depends on analysis of what unrelated

parties would have done in comparable circumstances, and to which evidence from uncontrolled transactions, properly adjusted, could be relevant. While the government focuses more on the second sentence of Section 482, this brief focuses on the first sentence of the statute.

Specifically, in Part I we argue that even if this Court accepts the argument that comparable uncontrolled transactions should be analyzed as part of the arm's-length standard, Treasury reasonably decided not to incorporate into the cost-sharing regulations the stock-based compensation sharing practices of unrelated parties engaged in joint ventures. Ignoring stock-compensation costs in controlled joint development agreements would violate the arm's length principle, notwithstanding evidence that supposedly shows that uncontrolled parties ignore such costs. This is because, as Treasury explained in promulgating the regulation, joint development agreements between controlled and uncontrolled parties "do not share enough characteristics," T.D. 9088, 68 Fed. Reg. 51,171, 51,173 (Aug. 26, 2003) to serve as valid comparables under the arm's length standard.

In Part II of this brief, we argue that Treasury's administrative process was valid, not arbitrary and capricious. We also argue that Treasury's regulatory interpretations merit deference.

We respectfully submit that the Tax Court decision should be reversed.

ARGUMENT

I. The purpose of the arm's length standard is to clearly reflect taxpayers' income, and the cost-sharing regulations advance that goal.

While uncontrolled transactions can provide useful guidance for determining an arm's-length price under Section 482, uncontrolled transactions are not relevant in every case, and even in cases where they are relevant, modifications must be made to account for relevant differences between the controlled and uncontrolled transactions. An uncontrolled transaction is only useful for making arm's-length determinations for controlled parties to the extent that the uncontrolled and uncontrolled transactions are *comparable*.

In this Part, we emphasize that stock-based compensation costs represent real economic costs—for both controlled and uncontrolled taxpayers. Due to lack of comparability between controlled and uncontrolled parties, however, treatment by uncontrolled parties of stock-based compensation costs in joint development agreements cannot be

imported into controlled transactions while still satisfying the clear reflection of income objective in the first sentence of I.R.C. § 482. But simply ignoring stock-based compensation costs also would fail the statute's goal to clearly reflect related parties' income. Treasury resolves this dilemma in part by offering controlled taxpayers the safe harbor in the challenged regulation. The safe harbor protects controlled taxpayers from an arm's-length income re-allocation under Section 482, provided those taxpayers share all costs (including stock-based compensation costs) proportionately to the benefits expected from the jointly developed intangibles. *See* Treas. Reg. § 1.482-7(d)(1). This regulation is a reasonable interpretation of the statute, and it more faithfully effectuates the arm's-length standard and Congress's goals in enacting Section 482 than would ignoring such costs, an approach suggested by the Tax Court's ruling below.

A. Uncontrolled transactions must meet the comparability requirement to be useful for the arm's length method.

The policy justification for Section 482 provides important context for understanding its clear reflection of income objective. Among other things, Section 482 prevents taxpayer abuse. When uncontrolled taxpayers enter into a deal, each wants to secure as much after-tax profit for its owners as possible. Because the income from the deal will be split among unrelated

owners, uncontrolled taxpayers generally have every reason to allocate that income in accordance with economic realities, and so uncontrolled taxpayers view tax planning as a secondary concern.

In contrast, when legally distinct, but commonly controlled taxpayers enter into a deal, they seek to maximize after-tax profits for a *common* set of owners. Thus, they have a clear incentive to allocate income in order to minimize taxes. Because profits are commonly controlled no matter how they are split among the legally distinct affiliates, there is little downside to shifting income purely for tax purposes. The purpose of the clear reflection of income objective in Section 482 is to counter such efforts to avoid tax by ensuring that controlled taxpayers' income reflects their real economic activities.

Treasury historically has fulfilled Section 482's clear-reflection-of income objective by applying the arm's-length standard. The term "arm's length standard" describes the task of determining an allocation for controlled parties that "*would have been* realized if uncontrolled taxpayers had engaged in the *same transaction under the same circumstances*." Treas. Reg. 1.482–1(b)(1) (emphasis added).

Uncontrolled transactions may provide useful data for the arm's length standard. But the arm's length standard does not allow uncontrolled

transactions to be imported wholesale into controlled transactions, precisely because such unmodified importation would not clearly reflect income. Instead, uncontrolled transactions are useful for the arm's length standard to the extent they are comparable to a given controlled transaction. *See* Treas. Reg. 1.482–1(b)(1) (in the absence of identical uncontrolled transactions "an arm's length result generally will be determined by reference to … comparable transactions under comparable circumstances"). As a prerequisite to using an uncontrolled price from a transaction that is not identical to the instant transaction, the arm's length standard requires "comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in *comparable* transactions under *comparable* circumstances." Treas. Reg. § 1.482-1(d)(1) (emphasis added). "[C]omparability … must be evaluated considering all factors that could affect prices or profits in arm's length dealings." *Id.* "In order to be considered comparable to a controlled transaction, an uncontrolled transaction … must be sufficiently similar that it provides a reliable measure of an arm's length result." Treas. Reg. § 1.482-1(d)(2). Even if transactions are comparable, the regulations require adjustments for "material differences" "based on commercial practices, economic principles, or statistical analyses." *Id.* The goal of limiting uncontrolled data to

comparable transactions and making such adjustments is to clearly reflect income.

The Tax Court has recognized that acceptable treatment by Treasury of controlled parties under the arm's-length method may differ from transactions between unrelated parties. "There is nothing in the language of section 482 or its corresponding regulations that is inconsistent with applying section 482 to transactions between subsidiary corporations that might not occur in similar form between unrelated taxpayers." *Foster v. Commissioner*, 80 T.C. 34, 149 (1983) (quoting *Northwestern Nat'l Bank of Minneapolis v. U.S.*, 556 F.2d 889, 890 (1977)), *aff'd in part* 756 F.2d 1430 (9th Cir. 1985).

Particularly for high-profit intangibles, there are important and systemic differences between controlled and uncontrolled taxpayers that make importation of uncontrolled transactions to the controlled setting especially unlikely to result in clear reflection of income. Controlled firms often have an advantage in the development and ownership of intangibles. A controlled firm can minimize contracting and other transaction costs, consistent with the theory of the firm. *See* R.H. Coase, *The Nature of the Firm* 4 Economica 386, 390 (1937). Internal ownership of key intellectual property avoids the hold-up problems that arise if a person outside the firm claims a

right to the intellectual property, which is one reason why firms hold such high-profit assets within the firm. *See* Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. Econ. Lit. 595, 603 (2000). The lived experience is that firms, particularly high-technology firms like Altera, carefully guard ownership rights to their valuable intellectual property.

B. Stock compensation costs are real economic costs for both related and unrelated taxpayers.

One issue in this case is whether stock compensation costs are real costs. The answer to this question is important because if stock costs are real costs, then any standard, including arm's length, that hopes to clearly reflect income must account for them. The Tax Court accepted Altera's argument that stock-based compensation costs were not explicitly addressed in uncontrolled joint development agreements because such compensation does not represent an economic cost. *See Altera*, slip op. at 62-65. This argument is incorrect. Stock-based compensation costs are real costs, and no profit-maximizing economic actor would ignore them. As Treasury stated, "employee compensation" is a "critical elemen[t]" of intangible development costs and is part of the "actual economic activity" undertaken by a cost-sharing participant. 68 Fed. Reg. at 51,173.

One way to understand the equivalence of cash and stock-based compensation expense is to assume a company issued new stock in exchange for cash. The company could use the cash received from the stock issuance for any number of purposes. Suppose it decides to use it to pay cash compensation to an employee. The employee in turn might use the cash to purchase the same newly issued stock. The use of stock-based compensation achieves the same economic objective as issuing stock for cash and paying the cash as compensation to employees.

Compensation in the form of stock or stock options shifts corporate assets to employees and away from other holders of interests in the firm, such as stockholders or creditors. Economists understand that "[g]ranting options to employees rather than selling them to suppliers or investors involves an actual loss of cash to the firm." Zvi Bodie, Robert S. Kaplan, and Robert C. Merton, *For the Last Time: Stock Options are An Expense*, 81 Harv. Bus. Rev. 63, 64 (2003). Treating stock-based compensation as a cost comports with the treatment extended to stock-based compensation not only in the federal income tax law but also in financial accounting, and in other areas of market practice.

The Tax Court dismissed the 2004 financial accounting guidance that required all firms to use the fair-value-based method for stock-based compensation because this guidance came after the finalization of the Treasury regulations at issue in this case. *Altera*, slip op. at 67 (note 28). But it is the *reasoning* of the financial accounting standard setters, publicly articulated since at least 1995, that is persuasive. In its 1995 release, the Financial Accounting Standards Board explained that it "continues to believe that financial statements would be more relevant and representationally faithful if the estimated fair value of employee stock options was included in determining an entity's net income, just as all other forms of compensation are included. To do so would be consistent with accounting for the cost of all other goods and services received as consideration for equity instruments." Statement of Fin. Accounting Standards No. 123: Accounting for Stock-Based Compensation 25 (1995).

Treating stock option and other stock-based compensation as costs for accounting purposes is now routine. This is evidenced by Altera's own accounting practice. It is also demonstrated by other companies' disclosures. For instance, Pfizer Inc.'s 2015 financial statement shows that such costs are not only treated as expenses, but also are allocated to research and development and to other corporate functions:

> "Generally, grants under share-based payment programs are accounted for at fair value and these fair values are generally amortized on a straight-line basis over the vesting period into *Cost of sales*, *Selling, informational and administrative expenses* and/or *Research and development expenses*, as appropriate."

Inc. Annual Report on Form 10K for Fiscal Year Ending December 31, 2015, Pfizer Inc. 2015 Financial Report, at 77 (italics in original).

Another piece of evidence that stock-based compensation is a measurable cost is that controlled foreign subsidiaries of U.S. multinational corporations regularly reimburse U.S. parent companies for stock option tax deductions when it is advantageous from a global tax perspective in order to obtain a deduction for foreign tax purposes. See T. Scott McMillen, *Securing a Tax Deduction Globally for Equity Awards*, 41 J. Corp. Tax'n 39, 40 (2014). Tax journals have included discussions of such planning since at least 1997. Brian K. Wydajewski, *Compensation and Fringe Benefits*, 23 J. Corp. Tax'n 386, 389-91 (1997).

C. Both uncontrolled and controlled taxpayers account for joint-development stock-based compensation costs

Treasury recognized that to clearly reflect income, uncontrolled parties, like controlled parties, must take account of stock-based

compensation, since such compensation is an economic cost. In its Preamble to the challenged regulation, Treasury said:

> These final regulations reflect that at arm's length the parties to an arrangement that is based on the sharing of costs to develop intangibles … would ensure through bargaining that the arrangement reflected all relevant costs, including all costs of compensating employees for providing services related to the arrangement. Parties dealing at arm's length in such an arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation.

68 Fed. Reg. at 51,173.

But how can one square this conclusion with the evidence offered by Altera of joint development agreements in which uncontrolled taxpayers did not mention such costs? Treasury in its Preamble recited the answer: "through bargaining," uncontrolled parties to a joint-development agreement account for the compensation of employees who contribute to joint development of the intangible in question. This bargaining need not manifest in explicit provisions for cost sharing in the uncontrolled parties' contract.

First, if the compensation costs for each party are proportional to the benefits each expects to receive from the joint venture, the parties can achieve the economic objectives of their deal *without referencing employee-*

compensation costs, including stock-option costs, in their agreement. Take the following example:

> **Example 1: Compensation costs proportional to expected benefits**. Company A and Company B are not commonly controlled and want to share the R&D costs for a new innovation on a 50/50 sharing ratio (based on expected future benefits from the innovation). Company A and Company B will jointly own the resulting intellectual property on a 50/50 basis. Company A pays cash compensation of 80 and grants stock options with a cost of 20 for its R&D employees. Company B pays cash compensation of 80 and grants stock options with a cost of 20 for its R&D employees.

In this example, taking stock-option costs into account, the pool of expenses is 200, and each company pays 100, so neither needs to transfer a cost-sharing payment to the other to effectuate their goal of a 50/50 split. The same result obtains, meaning that no cost-sharing payment is necessary, if the proportional (to expected future benefits) stock option costs are disregarded and the pool of expenses is 160. Since each company has 20 in stock option costs, and each owns an equal share of the resulting IP, their

economic deal will be fulfilled *absent any sharing of stock-based compensation*.

Second, if the compensation cost for each party is disproportionate to its expected benefit, then the logic of the free market demands that the parties will correct for that asymmetry by adjusting the terms of their agreement or through an associated transaction. Such an adjustment need not take the form of a proportional compensation cost-sharing term. Take the following example:

> **Example 2: Stock-based compensation costs disproportionate to expected benefits**. Company C and Company D are not commonly controlled and want to share the R&D costs for a new innovation on a 50/50 sharing ratio (based on expected future benefits from the innovation). Company C and Company D will jointly own the resulting intellectual property on a 50/50 basis. Company C pays cash compensation of 80 and grants stock options with a cost of 20 for its R&D employees. Company D pays cash compensation of 20 and grants stock options with a cost of 80 for its R&D employees.

If stock option expenses are included, the pool of expenses is 200, and each company pays 100, so no cost-sharing payment is necessary. This is the correct answer.

If stock option expenses are disregarded, however, the pool of expenses *appears to be* 100, and Company D appears to contribute only 20 to the pool of expenses. Under this (incorrect) analysis, Company D would be required to make a net payment of 30 to Company C as its share of costs. In other words, Company D and its shareholders will suffer an additional compensation burden of 30 if the stock-based compensation costs are not shared. This burden would be in addition to the 20 of cash compensation expense and the 80 of stock-based compensation expense that Company D already incurs.

The correct way to analyze this transaction is to treat Company C's 20 of stock-based compensation, and Company D's 80 of stock-based compensation expense, as costs. In Example 2, if the managers of Company D are fulfilling their fiduciary obligations, they should require on these facts that the costs to be shared take account of stock option compensation *or that an adjustment be made to some other element of the agreement or in an associated transaction to achieve the same result*.

To deny this would be to repeal a law of free markets – Company C cannot receive something for nothing. Only one of two conclusions can be drawn if Company D's management does not negotiate to take account of the cost of stock option compensation expense: (i) an adjustment is made elsewhere in the arrangement, or (ii) management is not doing its job (in academic parlance, there is an agency problem).

D. Evidence about uncontrolled parties' treatment of stock-based compensation costs in joint development agreements is not comparable to controlled parties' treatment of such costs in QCSAs.

As the discussion of Example 2 shows, the proffered evidence that taxpayers claim shows that uncontrolled parties do not share stock-based compensation costs in joint development agreements is incomplete. A complete picture of the uncontrolled transaction would require data on what or how other aspects of the deal were negotiated to accommodate the parties' desire to avoid the difficult problem of sharing option costs across uncontrolled companies. Treasury pointed to the incompleteness of this data in the Preamble to the final regulations, when it said that uncontrolled parties might make various adjustments in lieu of sharing stock-based compensation costs in joint development agreements. Treasury offered examples including a "service fee" or "contingent royalty." 68 Fed. Reg. at 51,173.

Such other adjustments might be particularly attractive substitutes for the sharing of stock-based compensation because uncontrolled parties might prefer not to take on the risk of a counterparty's stock, or because the parties prefer not to create an incentive for one party to depress the value of the other's stock. This additional risk is not present in a controlled party transaction, since controlled affiliates are already exposed to risks inherent in the parent corporation's stock.

Moreover, in controlled party QCSAs, the compensation costs tend to be extremely disproportionate, since one party (such as the U.S. parent) often incurs the great majority of costs for the development of intellectual property, even if, as in Altera's case, about 80% of the sales revenue generated by such intangibles comes from sales outside North America. *See* Altera Corporation, Annual Report Filed on Form 10-K for the fiscal year ended December 31, 2014, at 35.

Thus, there are material differences between controlled and uncontrolled parties' attitudes, motivations, and behaviors regarding stock-based compensation. As a result, it would be improper under the arm's length standard to import uncontrolled parties' treatment of such compensation to the controlled context. To use the uncontrolled transactions in this way would violate the clear reflection of income objective that

Congress set forth in the statute, as historically implemented by the arm's length standard.

In a case such as this one, where it is unclear how to extrapolate from controlled practice (where parties do not share stock costs, but instead modify other parts of their deal) to uncontrolled practice, it does not further the statutory goal of clear reflection of income to nevertheless use the controlled price without modification. The challenged regulation allows the taxpayer to avoid the difficulties and risks presented by the prospect of adjusting the uncontrolled transaction for the controlled context. Under the challenged regulation, the taxpayer can elect instead to use a QCSA, under which the taxpayer avoids a Section 482 reallocation of income, as long as it shares "all costs," including stock costs, proportionately with the expected benefits of the jointly developed intangible. Neither Altera nor the Tax Court disputed the reasonableness of the overall approach of the cost-sharing regulation. Under that approach, Treasury agrees to respect the controlled taxpayers' allocation of income, provided the taxpayers share all costs in proportion to their expected benefits. If this cost-sharing approach is valid, and if stock-compensation costs are real costs, then it logically follows that Treasury reasonably requires stock-compensation costs to be shared.

Including these real costs more faithfully effectuates Congress's goals in enacting Section 482 than would ignoring such costs, an approach suggested by the Tax Court's ruling below.

E. The question of comparability was not fully considered in the *Xilinx* case.

The Tax Court appeared not to consider the argument that Section 482's clear-reflection-of-income standard precludes Treasury from basing controlled party pricing on uncontrolled transactions that are not comparable. That is, the *Altera* Tax Court did not analyze whether the uncontrolled party joint development agreements cited by taxpayers are comparable to controlled party QCSAs. The Tax Court below did cite its opinion in *Xilinx*, a case involving stock-based compensation costs in QCSAs that arose before the regulatory amendments at issue in this case took effect. The *Altera* Tax Court stated that the *Xilinx* Tax Court relied on evidence of such uncontrolled party joint development agreements as "comparable" transactions. *Altera*, slip op at 61-62 (citing *Xilinx Inc. v. Commissioner*, 125 T.C. 37, 58-62 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). But the Tax Court did not explain, either below or in the *Xilinx* case, why it thought the uncontrolled party joint development agreements were "comparable" and thus could be used as evidence of why controlled parties

also would not share stock-based compensation costs. The portion of the *Xilinx* Tax Court case cited by the *Altera* Tax Court lists reasons why uncontrolled parties do not explicitly share such costs in joint development agreements, including a reluctance to accept the risk of a counterparty's stock. *Xilinx*, 125 T.C. at 58-62. This factor is one reason why the uncontrolled party joint development agreements are *not* comparable to controlled party QCSAs and thus cannot be used as reliable evidence for comparability. In addition, neither Ninth Circuit decision in *Xilinx* directly engaged the argument that the uncontrolled party joint development agreements could not be used as relevant evidence because of a lack of comparability. *See Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010); *Xilinx Inc. v. Commissioner*, 567 F.3d 482 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010).

If the *Xilinx* litigation had included the question of whether the controlled and uncontrolled party joint development costs were comparable, perhaps that question would have influenced the *Xilinx* outcome. If the arm's length standard means (as we submit) that Treasury should not look to incomparable uncontrolled transactions to set related party prices, then Treasury correctly disregarded uncontrolled party joint development

agreements even before the 2003 stock-based compensation regulation at issue in this case.

It is, however, possible to both consider *Xilinx* correctly decided and conclude that the regulation in the instant case is valid. The issue of comparability was not presented in the *Xilinx* opinions in connection with the promulgation of a final regulation following a full and complete notice-and-comment administrative process. To uphold the Treasury's action in this case, it is sufficient for this Court to conclude that Treas. Reg. § 1.482-7(d)(2) is not arbitrary and capricious. The argument in the instant case that Treasury made an adequate comparability analysis, even if it differs from a finding made a decade before in the context of the case presented in *Xilinx*, provides one avenue to such a holding.

II. Treasury's regulations are not arbitrary and capricious, but are a valid exercise of its authority under the APA.

Part I argued that it was reasonable for Treasury to refuse to use data from incomparable uncontrolled transactions as a benchmark for arm's-length pricing of cost-sharing arrangements under Section 482. This Part argues that not only was the decision reasonable, but that Treasury provided adequate reasons for its decision in the notice-and-comment period before

promulgating the final regulation. It therefore met its burden under the APA.

A. Treasury's regulations are not arbitrary and capricious.

This case involves the validity of final Treasury regulations. The regulation was promulgated in accordance with the procedures described in Section 553 of the APA, which include notice, an opportunity for public comment, "consideration of the relevant matter presented," and "a concise general statement of [the regulations'] basis and purpose." 5 U.S.C. § 553(c). The Tax Court decision focused on the APA provision authorizing a court to set aside a regulation that is "arbitrary" and "capricious." 5 USC § 706(2)(A). Under the arbitrary and capricious standard, "an agency must give adequate reasons for its decisions." *Encino Motorcars, LLC v. Navarro*, 2016 WL 3369424, at *1 (U.S. June 20, 2016). This Treasury did. The six-page Preamble explains that the Section 482 regulations address how to allocate income and deductions with a focus on "high-profit intangibles" owned by controlled parties, which was a policy issue identified in connection with the enactment of the 1986 Act. The Preamble explains that uncontrolled party data is unlikely to provide good pricing comparables in the case of such intangibles, and it sets aside uncontrolled party data offered in the notice-and-comment process—including the data at issue in

this case— because, as anticipated by Congress in its 1986 legislation, such data does "not share enough characteristics of QCSAs involving the development of high-profit intangibles." 68 Fed. Reg. at 51,172-51,173.

The Preamble explains and responds to each category of comments received in the notice-and-comment period. It reveals that Treasury "relied on factors which Congress … intended it to consider," "consider[ed] [the] important aspect[s] of the problem," and "offered an explanation for its decision" consistent with "the evidence before the agency." *State Farm*, 463 U.S. at 43. Also, Treasury's rule is not "implausible;" instead, it reflects "agency expertise." *Id.* Amici would have come to the same conclusion as Treasury.

The Tax Court concluded, based on its analytical focus on the question of whether uncontrolled parties explicitly share stock option costs, that "Treasury necessarily decided an empirical question when it concluded that the final rule was consistent with the arm's-length standard." *Altera*, slip op. at 45. We respectfully submit that this is a key misstep in the Tax Court's analysis.

No empirical finding that uncontrolled parties do, or might, share stock-based compensation costs is required to support Treasury's regulation. As the Government's brief argues, no comparability analysis is required.

See Government Brief at 44-48. But even if a comparability analysis is important, Part I of this brief shows why Treasury correctly decided to set aside evidence about uncontrolled joint development agreements. Nor did Treasury fail to explain why it did not take the evidence into account. As Treasury explained, "The uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles to establish that parties at arm's length would not take stock options into account in the context of an arrangement similar to a QCSA." 68 Fed. Reg. at 51,173.

Data that uncontrolled parties do not explicitly share stock option expense is not the same as evidence that they ignore that expense. Uncontrolled parties have every incentive to negotiate for adjustments to other terms if one party disproportionately contributes stock-based compensation to a joint development agreement, as explained above in the discussion of Example 2. Even if an explicit stock-based compensation sharing term is absent, Treasury reasonably concluded that parties "would ensure through bargaining that the arrangement reflected all relevant costs." 68 Fed. Reg. at 51,173. As the Preamble explains, many other deal terms might be adjusted, including a "service fee," "contingent royalty," "markups" or "non-cost-based service fees." *Id.*

After addressing these and other comments about the arm's length standard, Treasury also addressed additional comments. It explained, consistent with the conclusion in Part I.B of this brief, that stock-based compensation is a real economic cost, so that such compensation belongs to the category of "actual economic activity" that the cost-sharing regulations should reach. 68 Fed. Reg. at 51,173. Properly accounting for real economic costs serves the statutory goal of clearly reflecting income, and enforcing the statutory clear reflection of income objective is critical to combat multinational tax avoidance through profit shifting

B. No heightened "reasoned explanation" requirement applies, but if it did, it is satisfied.

Case law suggests that if an agency changes policy, a "'reasoned explanation'" for departing from the prior policy may be required. *See Organized Village of Kake v. U.S. Dep't of Agriculture*, 795 F.3d 956, 966 (9th Cir. 2015) (quoting *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515-16 (2009)). But the Treasury Department's treatment of stock option expense in the proposed and final regulations was not a change in policy. It was consistent with the position it had taken in publicly available guidance since at least 1997. *See* Government Brief at 14. The government's well-known litigating position in *Xilinx* was also consistent with Treasury's

longstanding position that stock-based compensation should be treated as costs in QCSAs.

Instead, Treasury responded to a change in the market for employee compensation, which saw an increase in the use of stock options during the 1990s. *See* Bodie et al., 81 Harv. Bus. Rev. at 63 (noting tenfold increase in 1990s). Treasury reacted by seeking to formalize its existing approach to stock-based compensation. This is an example of an agency responding to a marketplace or technological change by elaborating an existing policy to address increasingly prevalent fact patterns. It does not involve "initial agency action and subsequent agency action undoing or revising that action," *Fox Television*, 556 U.S. at 514. This is not like cases that involve rescinded regulations or other clear policy about-faces, *see, e.g.*, *Encino Motorcars*, 2016 WL 3369424, at *8 (U.S., June 20, 2016) (reviewing 2011 change in classification of auto service personnel under overtime rules after DOL had taken the opposite view for many years in administrative practice); *State Farm*, 463 U.S. at 37-38 (considering the rescission of a regulation that required passive safety devices in automobiles).

However, if a heightened reasoned explanation requirement did apply, Treasury's Preamble met the requirement, as explained above. Treasury sufficiently explained why it set aside evidence about uncontrolled party

joint development agreements. The explanations are more extensive than, for example, the DOL's explanations found wanting in *Encino Motorcars*, where the agency said little more than "'there are circumstances under which the requirement for the [overtime] exemption would not be met.'" *Encino Motorcars*, 2016 WL 3369424, at *9 (U.S. June 20, 2016) (quotation marks and citation omitted).

C. Treasury's regulatory interpretations deserve deference under *Auer* and *Seminole Rock*.

We submit that Treasury's regulations unambiguously condition the use of uncontrolled data in the arm's length method upon the requirement that the uncontrolled transaction is comparable to the controlled transaction. We also agree with the Government's arguments in this case that Treas. Reg. 1.482-7(d)(2) and the coordinating regulations make clear that in the cost-sharing context the arm's length standard can be satisfied without reference to *any* data from uncontrolled parties, no matter how comparable. Government Brief at 44-48.

Nevertheless, if the term "arm's length standard" or the meaning of coordinating regulations is ambiguous in when applied to stock-compensation sharing costs, Treasury's interpretation should prevail.

A body of case law including *Auer v. Robbins*, 519 U.S. 452 (1997) and *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945) requires deference to agencies' interpretation of their regulations under certain circumstances. "If the regulation is unclear, we defer to the IRS's interpretation so long as it is not 'plainly erroneous or inconsistent with the regulation.'" *Minnick v. Commissioner*, 796 F.3d 1156, 1159 (9th Cir. 2015) (quoting *Christopher v. SmithKline Beecham Corp.*, 635 F.3d 383, 392 (9th Cir. 2011), *aff'd*, 132 S. Ct. 2156 (2012)) (quoting *Auer*, 519 U.S. at 461)).

An agency's understanding may not merit deference if it is unreasonable. *See generally* Steve R. Johnson, Auer/Seminole Rock *Deference in the Tax Court*, 11 Pitt. Tax Rev. 1, 10-12 (2013). For example, if the agency fails to give adequate notice of its policy, its interpretation may be unreasonable. *See, e.g.*, *SmithKline Beecham*, 132 S. Ct. at 2167. Although deference has been granted for positions described in briefs, *see, e.g.*, *Talk America, Inc. v. Michigan Bell Telephone Co.*, 564 U.S. 50, 67 (2011), the lack of a clear and authoritative statement by the agency may contribute to a lack of deference in some cases, *see, e.g.*, *Indep. Training & Apprenticeship Program v. California Dept. of Indus. Relations*, 730 F.3d 1024, 1035 (9th Cir. 2013) (refusing *Auer* deference to an amicus brief where there was "significant potential for unfair surprise").

Here, Treasury gave adequate notice of its policy and provided clear and authoritative statements. Moreover, its policy of including stock-based compensation in QCSAs' cost base was consistent with its position taken in publicly available guidance starting in 1997; consistent with its litigation position, as evidenced by the *Xilinx* case; and consistent with its 2002 notice of proposed rulemaking. The regulation here is like the regulation before this Court in *Minnick*, where this Court deferred to the IRS interpretation of a tax regulation. *See Minnick*, 796 F.3d at 1159-60 (9th Cir. 2015) (deferring where the government contended that no deduction for a conservation easement was allowed unless the mortgagee bank had subordinated its interest at the time the property was transferred and the deduction claimed). Treasury's interpretation of its regulations in the instant case did not come as a surprise or present an internal conflict with other guidance. The regulations were promulgated with adequate notice and as part of a notice-and-comment rulemaking. Treasury's interpretation merits deference.

D. Treaty materials are consistent with Treasury's interpretation of the arm's length standard.

Contrary to the suggestion of the Tax Court, *Altera*, slip op. at 50-51, tax treaty materials do not undermine Treasury's definition of the meaning of "arm's length standard," whether alone or in conjunction with the term commensurate with income. The term "arm's length" is routinely used in U.S. technical explanations for Article 9 of tax treaties. *See, e.g.* United Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 9. The technical explanation does not address the issue before this Court, because Article 3(2) of the U.S. model income tax treaty, like the other models and also like all U.S. treaties, defers to the law of the country applying the treaty to define a term not defined in the treaty. *See* United States Model Income Tax Convention of November 15, 2006, Art. 3(2). The Article 25 mutual agreement procedure allows for the resolution of disputes when different countries' laws would reach different results. *See, e.g., id.* Art. 25.

International practice is in fact quite varied, and it is not confined to a reliance on uncontrolled third-party data. For instance, Canada, historically the largest U.S. trading partner and a treaty partner with frequent transfer pricing disputes with the United States, also employs its arm's length standard in a manner that does not merely look at third party transactions to

determine income allocations, but rather requires consideration of "the economic and business reality" of taxpayers. *Canada v. GlaxoSmithKline Inc.* [2012] S.C.R. 3 (Can.), para. 53 (refusing to accept tax administration's argument that generic price for a drug ingredient of a few hundred dollars invalidated intercompany price of more than $1500 where other rights were also transferred).

III. Remand is the proper remedy for any infirmity in the regulations.

If this Court decides, contrary to the arguments presented in this brief, that Treasury's 2003 regulations have an infirmity, the question of remedy will arise. The best remedy is to remand to Treasury for further consideration. This is consistent with applicable judicial precedent, which allows remand to an agency "when equity demands." *Idaho Farm Bureau Federation v. Babbitt,* 58 F.3d 1392, 1405 (9th Cir. 1995). Remand would also be consistent with the interests of sound tax administration. Any error made by Treasury in its explanation of the final rule was harmless and remand without vacatur would be the correct remedy.

If this Court finds the regulatory provision at issue here invalid but does not remand to Treasury for reconsideration, what should become of the *de facto* regulatory cost-sharing safe harbor as a whole after one of its

requirements is held invalid? Altera has challenged one essential part of a carefully constructed multi-part regulatory provision, designed to allow taxpayers protection against the risk of an *ex post* income allocation where a QCSA satisfies the conditions of the regulations. When all requirements of the QCSA regulations have been met, Treasury has determined that outcomes will result in clear reflection of income. The taxpayers appear to assume that the regulatory requirements may be cherry-picked, such that inclusion of stock-based compensation in the cost-sharing base may be deleted, while the remainder of the regime is left intact.

On the contrary, for reasons described above, deletion of stock option expense from the pool of allocable costs would leave in place an unbalanced regime that in most cases would fail to clearly reflect income and undermine the goal of the statute to curb tax avoidance. Such a regulatory regime would be so flawed that it could not appropriately execute Treasury's responsibility to ensure clear reflection of income, and Treasury might reasonably conclude that it should withdraw the safe harbor. Under this analysis, if Treas. Reg. 1.482-7(d)(2) were not valid, then taxpayers would face the default *ex post* allocation regime instead of benefiting from the protection of the QCSA safe harbor.

CONCLUSION

For the foregoing reasons, amici respectfully request that the Court reverse the judgment of the U.S. Tax Court.

Respectfully submitted,

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STATEMENT OF RELATED CASES

Amici respectfully inform the Court that they are not aware of any cases related to the instant appeal that are pending before the Court.

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME, TYPEFACE AND TYPE STYLE REQUIREMENTS

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 6980 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). The word count was computed by Microsoft Word 2011, the word processing program used to prepare this brief.

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2011 in 14-point Times New Roman typeface.

/s/ Susan C. Morse

Dated: July 1, 2016

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 July 1, 2016.

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, except for the following participant, whom we will serve by U.S. mail.

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