Tax Court Invalidates Stock-Based Compensation Amendment in *Altera*

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On July 27, 2015, the U.S. Tax Court, in *Altera Corp. and Subsidiaries v. Commissioner*, 145 T.C. No. 3, invalidated a 2003 amendment to Treas. Reg. §1.482-7(d)(2) (2003 Amendment) that required controlled participants in a qualified cost-sharing arrangement (QCSA) to include the cost of stock-based compensation (SBC) in the pool of costs to be shared among them. Judge L. Paige Marvel, in a decision reviewed by the full Tax Court, held that the 2003 Amendment did not reflect reasoned analysis and failed to respond to the record evidence and extensive public comments submitted during the rulemaking process.

Background

The Section 482 regulations addressed in *Altera* were issued on an expedited basis in a 13-month period ending in August 2003. Predating the regulation project, the Internal Revenue Service (IRS) litigated a related issue under predecessor Section 482 regulations issued in 1968.[1] By 2002, the IRS was also litigating a similar issue under the 1995 Section 482 regulations.[2] In *Xilinx*, the Tax Court and the U.S. Court of Appeals for the Ninth Circuit ultimately held that these regulations did not require taxpayers to include the value of SBC in connection with QCSAs.

In contrast to the 1968 and 1995 Section 482 regulations, which directed that "all costs" be shared under QCSAs, the 2003 Amendment specifically identified SBC and provided that a QCSA would produce an arm's length result if and only if SBC was included in the cost pool. The 2003 Amendment also specified two valuation methods for SBC: a default method (based on grant date), widely available to all taxpayers, and an elective method (based on exercise date), available to certain publicly traded corporations that validly elected the method.

During the rulemaking process that led to the 2003 Amendment, commenters challenged the authority of the Department of the Treasury and the IRS to issue the regulation in the form proposed. Among other things, many commenters emphasized that there was no evidence that uncontrolled parties shared the cost of SBC when they entered into agreements to perform research and development on a joint or cooperative basis. Absent evidence that uncontrolled parties accounted for SBC in transactions comparable to QCSAs, commenters argued, Treasury and the IRS lacked authority to require controlled taxpayers to include SBC in QCSAs.

The Decision

In *Altera*, the Tax Court applied the *Xilinx* analysis and concluded that Treasury and the IRS failed to engage in "reasoned decisionmaking" in adopting the 2003 Amendment. The court first determined that the 2003 Amendment was a legislative rule, not an interpretive rule. Under Section 553 of the Administrative Procedure Act, the 2003 Amendment was subject to certain notice and comment requirements. Over objections by the IRS, the court analyzed whether the regulation satisfied the notice and comment requirements under the standard of *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1984). Under the *State Farm* standard, an agency must examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made.[3]

[1] *See Seagate Technology, Inc. v. Commissioner*, TC Memo 2000-338.

[2] *Xilinx, Inc. and Subs. v. Commissioner*, 125 T.C. 37 (2005), rev'd, 567 F.3d 482 (9th Cir. 2009), withdrawn, 592 F.3d 1017 (9th Cir. 2010), aff'd, 593 F.3d 1191 (9th Cir. 2010).

[3] In response to arguments that the case should be analyzed under the test in *Chevron U.S.A., Inc., v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) instead of the *State Farm* standard, the court concluded that the *Chevron* steps incorporated the reasoned decisionmaking standard of *State Farm*.

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The Tax Court's application of the *State Farm* standard involved four main elements; in each element, the Tax Court found against the IRS. The first element was whether the 2003 Amendment had a basis in fact. One of the IRS arguments in the case was that Treasury should be permitted to issue regulations modifying or even abandoning the arm's length standard. However, as the Tax Court pointed out, Treasury and the IRS did not seek to justify the 2003 Amendment on the grounds that it modified or abandoned the arm's length standard. In fact, Treasury and the IRS intended to adhere to the arm's length standard, stating in the preamble to the 2003 Amendment that they "believed" that parties would share SBC. The court concluded that that belief was flatly contradicted by the lack of empirical evidence that parties at arm's length would share SBC.

The second element was whether the IRS rationally connected its choice to adopt the 2003 Amendment with the facts that it found. The court saw no rational connection between the two, and it rejected as a justification for the 2003 Amendment that unrelated parties entering into QCSAs to develop "high profit intangibles" would share SBC if such compensation were a significant element of the pool of costs under the QCSA. The court found that since many QCSAs did not involve high profit intangibles in which SBC is a significant element, the explanation for including SBC in all QCSAs was inadequate. The court also rejected the IRS' arguments that the 2003 Amendment should apply to all QCSAs because the amendment eased administrative burdens.

The third main element was whether the IRS responded to significant public comments. The court determined that the IRS failed to respond meaningfully to numerous relevant and significant comments noting that unrelated parties do not share SBC and would not do so because the value of such compensation is speculative, potentially large and outside the parties' control.

The fourth element was closely related to the third point: whether the 2003 Amendment was consistent with the evidence before the IRS. As stated above, the court concluded that the 2003 Amendment was contrary to the evidence put before the IRS.

Impact of the Decision

After the 2003 Amendment, many affected taxpayers included protective language in their QCSAs, which reserved the right to make adjustments if the 2003 Amendment were found to be invalid. Whether those taxpayers will be able to satisfy the procedural requirements for refunds in one or more tax years will depend on their specific facts and circumstances, but *Altera* suggests that the substantive predicate for a refund claim may be present.

Also, *Altera* could lead taxpayers to challenge other provisions of the Section 482 regulations. For example, Treas. Reg. §1.482-9(j) requires that taxpayers include SBC in "total services costs" used to evaluate certain controlled services transactions, and Treas. Reg. §1.482-5(c)(2)(iv) states that adjustments for material differences in accounting for SBC can be appropriate under the comparable profits method. *Altera* could open the way for challenges to the rulemaking processes for those provisions.

Altera also may call into question the validity of other provisions in the Section 482 regulations, particularly provisions where Treasury and the IRS prescribed a course of conduct without considering how uncontrolled parties may have treated similar items in arm's length transactions. Historically, Treasury and the IRS have rejected the view that the conduct of uncontrolled parties is directly relevant to the regulations adopted under Section 482, and one of the IRS arguments in *Altera* was that the agency may issue regulations that modify or abandon the arm's length standard. So long as Treasury and the IRS consider the arm's length standard to be the touchstone under Section 482, however, the conduct of uncontrolled parties may in some cases prove to be a controlling consideration, as confirmed by the outcome in *Altera.*

The Tax Court has ruled on several challenges to Treasury regulations since the landmark 2011 decision in *Mayo*,[4] although *Altera* is the first case to evaluate a regulation issued under Section 482. The U.S. Supreme Court's decision in *Mayo* rejected the multifactor test[5] traditionally applied to income tax regulations and held that such regulations were subject to the *Chevron* standard, which applied to determinations by other federal agencies. Although the Tax Court applied the *State Farm* standard here, it concluded that the same analysis would apply under *Chevron*. The robust analysis the Tax Court applied in this case should alleviate concerns that *Mayo* might require too much deference to the agency's factual and legal determinations.

[4] *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44 (2011).

[5] *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979).