XIII. The Aftermath(?) of Altera*: Implications for Multinational Corporations*

A. Introduction

Effective tax regulation in the twenty-first century must inevitably confront the problem of how to value and tax cross-border transactions between parent corporations and their controlled foreign entities, known as "transfer pricing."[1] In conducting such transactions, corporations seek to shift as much income as possible to foreign entities (often incorporated in low-tax jurisdictions), while allocating as many deductible expenses as possible to U.S. parent entities that face higher tax rates.[2] From a regulatory standpoint, transactions generally must conform to the arm's length standard—essentially, the consideration exchanged between related entities must be consistent with what two unrelated entities would exchange in a comparable transaction.[3]

For companies that incur substantial research and development costs, transfer pricing often takes the form of cost-sharing arrangements (CSAs) entered into between the United States and foreign subsidiary entities. Tech companies, including Facebook, Amazon, Apple, and Alphabet, are especially reliant on these arrangements as a tax reduction technique.[4] Participants in CSAs agree to share the research and development costs of developing intangibles (nonphysical & nonmonetary assets such as intellectual property) in

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[1] *See, e.g.*, Steven A. Dean, *Neither Rules nor Standards*, 87 NOTRE DAME L. REV. 537, 543–45 (2011) (discussing how the modern multinational company presents a significant challenge for taxing authorities).

[2] *See* Seth Brian, Altera Corp. v. Commissioner*: A Rare Government Victory in Transfer Pricing*, 87 U. CIN. L. REV. 1123, 1124–25 (2019) (discussing the basics of transfer pricing); Brief of J. Richard Harvey et al. as Amici Curiae Supporting Respondent-Appellant at 6, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) [*hereinafter* Harvey, Amicus Brief] (describing the incentives for corporations to shift income in controlled transactions).

[3] *See generally* JENS WITTENDORFF, *Transfer Pricing and the Arm's Length Principle in International Tax Law* 295–302 (2010).

[4] For an in-depth discussion of Apple's use of CSAs, see Debra Brubaker Burns, *Golden Apple of Discord: International Cost-Sharing Arrangements*, 15 HOUS. BUS. & TAX L.J. 55 (2015).

proportion to each entity's expected share of the financial benefits from any subsequent product developments.[5] The applicable regulation, Treasury Regulation § 1.482-7A (Regulation 1.482-7A), imposes a number of conditions for a CSA to be deemed by the Internal Revenue Service (IRS) to be a qualified cost-sharing arrangement (QCSA).[6] Qualifying as a QCSA provides firms a safe harbor from proposed reallocations by the IRS.[7] Consequently, multinational firms often seek to meet the regulatory requirements of a QCSA in order to avoid the uncertainty and potentially high transaction costs of a proposed reallocation.

In *Altera Corp. v. Commissioner*,[8] the question was whether subsection (d)(2) of Regulation 1.482-7A, which requires employee stock compensation's inclusion in a QCSA, was valid.[9] If invalid, corporations could exclude stock compensations from QCSAs and continue to use them as a significant set off against U.S. taxable income. If valid, then the costs would need to be partially allocated to foreign entities and the U.S. entities would face higher tax bills. After a protracted path through the Tax Court and two appellate oral arguments, the Ninth Circuit has (for now) answered that question in the negative: companies cannot exclude the cost of stock compensation from a QCSA.[10] The *Altera* decision is already beginning to have an impact in the corporate financial sphere, as major companies have disclosed substantial anticipated tax bills in recent filings with the Securities and Exchange Commission (SEC).[11]

This article discusses *Altera* and its potential effects on multinational corporations. Part B focuses on the background of *Altera* and the statutory and regulatory framework that it involved. Part C provides a survey of recent scholarly and practitioner reactions to *Altera* and the use of the arm's length standard. Finally, Part D concludes by discussing the implications of *Altera* for multinational companies and, more generally, for administrative tax law.

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[5] *See* Brian *supra* note 2, at 1124.
[6] Treas. Reg. § 1.482-1 (2019); Treas. Reg. § 1.482-7A(d)(2) (2019).
[7] *Id.*
[8] 926 F.3d 1061 (9th Cir. 2019).
[9] *Id.* at 1067.
[10] *Id.* at 1087.
[11] Joseph Boris, *Facebook, Google, Twitter Reveal Tax Hit from* Altera *Ruling*, LAW 360 (Aug. 5, 2019), https://www.law360.com/articles/1183880/facebook-google-twitter-reveal-tax-hit-from-altera-ruling.

B. Background

1. Statutory & Regulatory Background

Enacted in 1954[12] as part of the Internal Revenue Code (IRC), Section 482 provides a broad legal basis for the IRS's discretionary authority, stating that the Treasury "may distribute, apportion, or allocate gross income, deductions, credits, or allowances" between entities.[13] The statute's purpose is specifically noted in its text, which authorizes the IRS to take such actions in order to "prevent evasion of taxes or clearly to reflect the income."[14] The 1986 Tax Reform Act (1986 Act) later amended Section 482, codifying an additional requirement that, for transfers of intangibles, payments between related corporations must be "commensurate with the income" attributed to the intangible.[15] This new provision of the statute provided authorization for IRS to retroactively examine transactions to determine whether an entity's allocation of costs were in appropriate ratio to its receipt of profits.[16]

Although the words "arm's length" are never used in Section 482, the IRS has historically adopted the arm's length standard as the regulatory test for deciding what should be included.[17] Under the

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[12] The authorizing language of the first sentence in section 482 actually dates farther back to its original codification in the Revenue Act of 1928. *See* Clark, *infra* note 13, at 1166–67.

[13] I.R.C. § 482 (2019); *see also* Brief of Respondent-Appellant at 5, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497); Robert G. Clark, *Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony*, 42 AM. U.L. REV. 1155, 1166–67 (1993).

[14] I.R.C. § 482 (2018).

[15] *Id.* ("[T]he income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.");

[16] *Id.*; *see also* 1988 IRB LEXIS 3758 at *70 ("Congress determined that the actual profit experience should be used in determining the appropriate compensation for the intangible and that periodic adjustments should be made to the compensation to reflect substantial changes in intangible income as well as changes in the economic activities performed and economic costs and risks borne by the related parties in exploiting the intangibles.").

[17] *See* Treas. Reg. § 1.482-1(b)(1) (2019) ("In 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.")

standard, related entities in a CSA must share expenses in the same manner that two unrelated companies would share them in a comparable transaction.[18] The policy considerations behind the standard are relatively simple. With unrelated party transactions, regulators can rely on the interplay of each parties' economic interests to lead to a "natural" market price outcome, from which income can then be taxed.[19] But, related parties share the same economic interest and cannot be relied upon to reach market-driven price outcomes, as they are incentivized to structure transactions to achieve maximum value for the overall business.[20] Applying the arm's length standard thus restores fairness and tax parity between related and unrelated entity transactions, requiring that the consideration exchanged between related entities match what unrelated entities would exchange in a comparable transaction.[21]

In 1995, the Treasury adopted interpretive regulations addressing CSAs, which did not expressly discuss stock compensation.[22] The regulation provides a safe harbor from IRS reallocation for entities that satisfy the enumerated requirements to be a QCSA.[23] In 2003, responding to litigation on the issue and following notice and comment, the Treasury amended the regulation to add Regulation

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(emphasis added); *see also* Local Finance Corp. v. Comm'r, 407 F.2d 629, 632 (7th Cir. 1969) ("[T]he Commissioner is empowered to examine closely the transactions between controlled taxable entities to determine whether they are such as would have been consummated in an arm's length negotiation between strangers and to make an allocation when they fail to meet that standard.").

[18] Treas. Reg. § 1.482-1(b)(1) (2019).

[19] Stanley Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POLICY IN INT'L BUS. 409, 414 (1978) ("Tax administrators do not question transactions that are governed by the marketplace.").

[20] *Id*. ("[W]hen faced with intra-group transactions not governed by that marketplace but instead by the policies and goals of the overall enterprise, [a tax system] naturally seeks to replace the intra-group arrangement with the norm of the marketplace.").

[21] WITTENDORFF, *supra* note 3, at 7.

[22] Treas. Reg. 1.482-7 (1995) ; *see also* Damian Laurey, *Untangling the Stock Option Cost Sharing Loophole*, 55 TAX LAW. 761,767–68 (2002) (discussing the question of whether stock options count as costs under the 1995 regulations).

[23] *See* Harvey, Amicus Brief *supra* note 2, at 5.

1.482-7A, which expressly mandates the inclusion of stock-based compensation in a QCSA.[24]

2. Altera Corp. v. Commissioner[25]

The case at issue involved a CSA between the appellee, a U.S. corporation,[26] and its Cayman Islands subsidiary, in which the two entities shared research and development costs.[27] During the tax years in question, the arrangement did not include cost-sharing of stock-based employee compensation, which was allocated to the U.S. corporation.[28] The IRS later issued notices of deficiency for tax years 2004–2007, increasing taxable income each year for amounts varying between $15 million and $25 million.[29] Altera responded by filing a petition in Tax Court to challenge the proposed changes.[30]

The primary substantive conflict between Altera and the IRS revolved around whether Regulation 1.482-7A was consistent with the arm's length standard. Altera argued that Regulation 1.482-7A was arbitrary and capricious, because it required an allocation of expenses that would never be required under the traditional arm's length standard, which was neither properly explained nor justified during the notice and comment process.[31] Altera pointed to the language of

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[24] Treas. Reg. § 1.482-7A(d)(2) (2019) ("[Intangible development costs] mean all costs, in cash or in kind (including stock-based compensation)."); *see* Brief for Appellant-Respondent *supra* note 13, at 20 ("[D]uring the pre-trial phase of the *Xilinx* case (and in response to that litigation and similar disputes with taxpayers), Treasury issued (in proposed form) the 2003 cost-sharing amendments at issue here.").

[25] 926 F.3d 1061 (9th Cir. 2019).

[26] Altera Corp. was acquired in December 2015 by Intel. *See* Quentin Hardy & Chad Bray, *Intel Agrees to Buy Altera for $16.7 Billion,* N.Y. TIMES (June 1, 2015), https://www.nytimes.com/2015/06/02/business/dealbook/intel-altera-buy-chips-computers-chip-maker.html.

[27] Brief for Respondent-Appellant *supra* note 13, at 23.

[28] Altera Corp., 926 F.3d at 1073 (discussing Altera's decision to amend its cost sharing agreement in the aftermath of the Tax Court's decision in *Xilinx v. Comm'r*, 125 T.C. 37 (2005)).

[29] Altera Corp., 926 F.3d at 1074.

[30] *Id.*

[31] Brief for Petitioner-Appellee at 72, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) ("Accordingly, because it creates an absolute rule for stock-based compensation, requiring related parties to share a purported cost that unrelated parties never would share, the Final Rule is

numerous bilateral treaties and a prominent 1988 IRS bulletin (White Paper) to bolster its claim that the traditional arm's length standard still governs all Section 482 reallocations.[32] It further asserted that the IRS had failed to adhere to the arm's length standard in its treatment of the employee stock compensation, thus violating Treasury Regulation § 1.482-1(b)(1)'s requirement that the arm's length standard be applied "in every case."[33] Altera concluded that the Treasury violated the Administrative Procedure Act (APA) in proposing and adopting Regulation 1.482-7A without conducting sufficient fact-finding and response to substantive comments.[34]

The government countered by arguing that the arm's length standard does not require a comparable transaction analysis, at least since the 1986 Act's addition of the "commensurate with income" language.[35] Indeed, because unrelated parties would never share the costs of paying out compensation for shares of a company they do not control, there are simply no comparable unrelated party transactions with which to compare.[36] The government asserted that its interpretation of Section 482 as permitting a purely internal analysis was thus permissible in order to achieve an arm's length result and a clear reflection of corporate income.[37]

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arbitrary and capricious in substance, and therefore unenforceable under *Chevron*.").

[32] *Id.* at 11–12.

[33] *Id.* at 13.

[34] *Id.* at 38 ("The Secretary defied the APA's procedural requirements by promulgating a rule that ignores all of the evidence before the agency as well as eight decades of statutory, regulatory, judicial, and treaty precedents.").

[35] Brief for Respondent-Appellant *supra* note 13, at 34.

[36] Brief of Anne Alstott et al. as Amici Curiae Supporting Respondent-Appellant at 21, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) [hereinafter Alstott, Amicus Brief] ("Treasury's response also identifies a fundamental issue with stock-based compensation in cost-sharing agreements between unrelated parties: [t]he economics are entirely different than in an agreement between related parties."); *see also* Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 WORLD TAX J. 3, 8 (2010) ("[P]roblems with the current system derive . . . from a fallacy that lies at the system's central core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement.").

[37] Brief for Respondent-Appellant *supra* note 13, at 50–51.

In line with its precedent on CSAs and its general treatment of transfer pricing, the Tax Court was hostile toward the government's arguments.[38] On cross-motions for partial summary judgment, a fifteen-judge panel of the Tax Court unanimously held for Altera.[39] In the opinion, Judge Marvel focused on Altera's APA challenge, applying the *State Farm*[40] "reasoned decision-making" standard to find that the IRS regulation was arbitrary and capricious.[41] Judge Marvel found, *inter alia*, that the IRS had failed to support the changed regulations with empirical evidence showing its consistency with the arm's length standard and failed to adequately respond to submitted comments during the notice and comment phase.[42]

The IRS then appealed to the Ninth Circuit. Interestingly, the Ninth Circuit had dealt with a very similar controversy in *Xilinx v. Commissioner*[43] in 2010 and held for the corporate plaintiff. However, *Xilinx* was a challenge to the previous version of the regulation, which did not explicitly address stock compensation.[44] According to the majority opinion, this preserved the validity of the current Regulation 1.482-7A(d)(2) as a separate question for the court.[45]

The Ninth Circuit was less receptive to Altera's assertions in oral arguments and issued an initial opinion reversing the Tax Court.[46] However, the opinion was swiftly withdrawn following the death of the sitting Judge Stephen Reinhardt on March 29, 2018.[47] At the time

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[38] For other recent examples of the Tax Court ruling against the IRS in significant transfer pricing cases under section 482, *see, e.g.*, Amazon.com Inc. v. Comm'r, 148 T.C. No. 8 (2017), *aff'd*, 934 F.3d 976 (9th Cir. 2019); Medtronic Inc. v. Comm'r, T.C. Memo. 2016-112, *vacated*, 900 F.3d 610 (8th Cir. 2018), *remanded*; Veritas Software v. Comm'r, 133 T.C. 34 (2009); *see also* Xilinx v. Comm'r, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

[39] Altera Corp. v. Comm'r, 145 T.C. 91, 134 (2015).

[40] *See* Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983).

[41] Altera Corp., 145 T.C. at 133.

[42] *Id.*

[43] 598 F.3d 1191 (9th Cir. 2010).

[44] Altera Corp., 926 F.3d at 1086 ("The *Xilinx* panel did not address the "open question" of whether the 2003 regulations remedied the error identified in that decision.").

[45] *Id.* at 1086–87.

[46] *See* Altera Corp. v. Comm'r, 2018 U.S. App. LEXIS 20524 (9th Cir. 2018).

[47] Christopher J. Walker, *Nearly Four Months after His Death, Judge Reinhardt Casts the Deciding Vote in an Important Tax Exceptionalism Case:*

of his death, Judge Reinhardt had formally signed on to Chief Judge Sidney Thomas's majority opinion, but the dissenting opinion had not yet been circulated.[48] The Ninth Circuit withdrew the opinion and held the case over for re-argument in 2019, with Judge Susan Graber replacing Judge Reinhardt on the three judge panel.[49] Court observers had speculated that the partially reconstituted panel might receive the arguments differently, but after re-argument, Chief Judge Thomas issued a new majority opinion (joined by Judge Graber) that recycled much of the previous version.[50]

In his opinion reversing the Tax Court, Chief Judge Thomas found no APA violations and, in applying *Chevron*,[51] held that the regulation was a reasonable interpretation of Section 482.[52] Chief Judge Thomas conducted a lengthy analysis of Section 482's legislative history,[53] finding a strong congressional interest in achieving arm's length results.[54] Addressing Altera's arguments, the Chief Judge found statutory authority in the broad language of Section 482 "[i]n the

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Altera v. Commissioner of Internal Revenue, NOTICE & COMMENT (July 24, 2018), http://yalejreg.com/nc/nearly-four-months-after-his-death-judge-reinhardt-casts-the-deciding-vote-in-an-important-tax-exceptionalism-case-altera-v-commissioner-of-internal-revenue/ (discussing the problematic nature of "dead-hand voting" and the eventual opinion withdrawal); *see also* Sam Roberts, *Stephen Reinhardt, Liberal Lion of Federal Court*, *Dies at 87*, N.Y. TIMES (Apr. 2, 2018).

[48] Altera Corp., U.S. App. LEXIS 20524 at *3 n* (noting Judge Reinhardt's full participation and formal concurrence with the majority opinion).

[49] Joseph Boris, *9th Circ. Sets Oral Reargument in* Altera *Suit for October*, LAW 360 (Aug. 20, 2018), https://www.law360.com./articles/1075092/9th-circ-sets-oral-reargument-in-altera-suit-for-october; Kristen A. Parillo, *Ninth Circuit Withdraws* Altera *Opinion, New Judge to Weigh In*, TAX NOTES (Aug. 8, 2018) (observing that the opinion withdrawal was "self-correcting th[e] mistake" of originally releasing the opinion with Judge Reinhardt's vote).

[50] Steve Dixon, *Observations on Changes in the Ninth Circuit's Second* Altera *Decision*, TAX APPELLATE BLOG (June 27, 2019) https://appellatetax.com/2019/06/27/observations-on-changes-in-the-ninth-circuits-second-altera-decision/.

[51] *See* Chevron, U.S.A., Inc. v. NRDC, Inc. 467 U.S. 837 (1984).

[52] *Altera Corp.,* 926 F.3d at 1078.

[53] *Id.* at 1068–72.

[54] *Id.* at 1069–70 ("A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties . . . [M]ulti-national companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries.") (quoting from H.R Rep. No. 99-426 at 423 (1985)).

case of any transfer . . . of intangible property."[55] Chief Judge Thomas then determined that the 1986 Act's amendments to Section 482 evidenced congressional intent to permit the use of a standard purely "internal to the entity being taxed."[56] Given that the arm's length standard has historically been fluidly defined, Chief Judge Thomas concluded that Treasury reasonably understood Section 482 to allow purely internal allocation methods.[57] Finally, the Chief Judge quickly disposed of the APA challenge, finding that citations in the proposed rule to the legislative history of the 1986 Act's amendments[58] gave sufficient notice of the proposed change.[59]

Judge Kathleen O'Malley[60] wrote a vigorous dissent, focusing on the Treasury's rulemaking under the APA and finding the same procedural deficiencies that the Tax Court had recognized.[61] Judge O'Malley also addressed the majority's *Chevron* analysis, arguing that the Treasury's "post-hoc" interpretation that the commensurate with income standard applies to CSAs is impermissible, because CSAs do not involve "transfers of intangibles"[62] under the language of the statute.[63] Accordingly, in addressing the case at bar, Judge O'Malley

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[55] Altera Corp., 926 F.3d at 1076 ("That phrasing is as broad as possible . . .").
[56] *Id.* at 1077.
[57] *Id.* at 1078.
[58] *See* Compensatory Stock Options Under Section 482, 67 Fed. Reg. 48997, 48999 (proposed July 29, 2002) (codified at 26 C.F.R. 1.482-7A) ("In establishing rules for measurement of the operating expenses attributable to stock-based compensation for cost sharing purposes, Treasury and the IRS believe that due regard must be given to the emphasis placed on economic factors in the legislative history of the commensurate with income standard and in the White Paper.").
[59] *Altera Corp.,* 926 F.3d at 1082.
[60] Judge O'Malley of the Federal Circuit was sitting by designation. *See id.* at 1061 n**.
[61] *Id.* at 1096–97 ("I would hold, as the Tax Court did, that Treasury's belated arguments are insufficient to justify the 2003 regulations and that those regulations are, thus, are procedurally invalid.").
[62] In the majority opinion, Chief Judge Thomas addresses this by noting that QCSAs involve transfers of "future distribution rights to intangibles." *Id.* at 1076 & 1101–02.
[63] *Id*. at 1098 ("Treasury never made, much less supported, a finding that QCSAs constitute transfers of intangible property."); *see* I.R.C. 482 ("In the case of any transfer (or license) of intangible property, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.") (internal parenthetical omitted).

found that the *Xilinx* precedent should control the outcome, because, under her analysis, Regulation 1.482-7A was invalid.[64]

Altera subsequently filed a petition for rehearing *en banc*.[65] In the petition, Altera argued, *inter alia*, that the panel opinion was incompatible with *Xilinx* and upset the administration of tax law.[66] Multiple industry groups and corporations, including Amazon and Facebook, submitted amicus briefs on Altera's behalf, urging rehearing *en banc* due to the issue's significance.[67] After several months, the Ninth Circuit issued an order denying rehearing.[68] Of particular note, the order was accompanied by a forceful nineteen-page dissent by Judge Milan Smith (joined by Judges Bade and Callahan), which focused on the procedural APA infirmities of the regulation.[69] Dissents from denials of rehearing *en banc* traditionally play an important role in signaling the desirability of certiorari from the U.S. Supreme Court.[70] This dissent's publication sends a powerful message of the

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[64] *Id.* at 1101.

[65] *See* Petitioner-Appellee's Petition for Rehearing En Banc, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497).

[66] *Id.*; *see also* Steve Dixon, *Petition for Rehearing En Banc Filed in* Altera, TAX APPELLATE BLOG (July 24, 2019), https://appellatetax.com/2019/07/24/motion-for-rehearing-en-banc-filed-in-altera/.

[67] *See e.g.*, Brief of Amazon.Com Inc. as Amicus Curiae Supporting Petitioner-Appellee's Petition for Rehearing En Banc, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497); Brief of Cisco Sys. et al. as Amici Curiae Supporting Petitioner-Appellee's Petition for Rehearing En Banc, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) [hereinafter Cisco, Amicus Brief]; Brief of U.S. Chamber of Commerce as Amicus Curiae Supporting Petitioner-Appellee's Petition for Rehearing *En Banc*, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497).

[68] Interestingly, ten sitting judges of the 9th Circuit were recused from consideration of the petition for rehearing *en banc*. *See* Altera Corp. v. Comm'r, 2019 U.S. App. LEXIS 33668 at *10 (9th Cir. 2019).

[69] *Id.* (Smith, J., dissenting from denial of rehearing *en banc*) ("As recognized by the unanimous en banc Tax Court, Treasury's actions in this case are the epitome of arbitrary and capricious rulemaking".)

[70] Judge Berzon of the 9th Circuit (who voted in *Altera* to deny rehearing) has herself described such dissents as "often thinly (or not so thinly) veiled entreaties to the Supreme Court . . . essentially, judicial petitions for certiorari." Marsha S. Berzon, *Dissent, "Dissentals," and Decision Making*, 100 CALIF. L. REV. 1479, 1491 (2012); *see also* Jeremy D. Horowitz, *Not Taking "No" for an Answer: An Empirical Assessment of Dissents from Denial of Rehearing En Banc*, 102 GEO. L.J. 59, 80–81 (2013).

federal judiciary's lack of consensus, which the justices of the Supreme Court—who may soon deliberate over whether to grant certiorari in *Altera*—will not fail to notice. The Court's recent administrative law jurisprudence suggests that, if it does grant certiorari, it may be more receptive than the Ninth Circuit to Altera's arguments.[71]

Regardless of the future of the litigation, the IRS has begun to take steps to enforce the regulation, withdrawing a memorandum from August 2018 that had declared a moratorium on audits of the employee stock compensation issue.[72] Accordingly, the IRS is empowered to again conduct audits and issue deficiency notices proposing to reallocate employee stock costs.[73] In their active reactions to the *Altera* decision, both the IRS and affected multinational corporations have implicitly acknowledged the regulation has a substantial chance of being sustained going forward.[74]

C. Scholarship Survey

1. Reactions to the Ninth Circuit Decision

Altera has been the subject of significant discussion among tax practitioners and scholars in recent years.[75] In an article published

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[71] *See e.g.* Dep't of Commerce v. New York, 139 S. Ct. 2551, 2575 (2019) ("[W]e cannot ignore the disconnect between the decision made and the explanation given . . ."); Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2127 (2016) (vacating the Ninth Circuit's decision to uphold a regulation under *Chevron* deference, due to a lack of reasoned explanation by the agency and the presence of "serious reliance interests"); *see also* William M. Buzbee, *The Tethered President: Consistency and Contingency in Administrative Law*, 98 B.U. L. REV. 1357, 1396–1401 (2018) (discussing the Court's recent treatment of regulatory policy changes).

[72] I.R.S. Withdrawal of Directive LB&I-04-0118-005 (July 31, 2019) https://www.irs.gov/businesses/corporations/withdrawal-of-directive-lbi-04-0118-005.

[73] Natalie Olivo*, IRS Resumes Examining Cost-Sharing, Citing* Altera *Ruling*, LAW 360 (Aug. 5, 2019), https://www.law360.com./articles/1185272/irs-resumes-examining-cost-sharing-citing-altera-ruling.

[74] See Boris *supra* note 2.

[75] *See e.g.*, Edward Froelich, Altera v. Commissioner—*Administrative Procedure Act under Siege?*, BLOOMBERG TAX (Aug. 1, 2019), https://news.bloombergtax.com/daily-tax-report/insight-altera-v-commissioner-administrative-procedure-act-under-siege; Deloitte, *The Ninth Circuit Reverses the Tax Court*

after the initial issuing of the Ninth Circuit's withdrawn opinion, Seth Brian mirrors many of the arguments made by Altera and concludes that the opinion was wrongly decided. Brian asserts that the Ninth Circuit disregarded extensive precedent and legislative history establishing that the 1986 Act did not change the nature of the arm's length standard.[76] Consistent with Altera's arguments, Brian relies particularly on the IRS's issuing of the White Paper, which declared that a Section 482 allocation requires a comparability analysis.[77] Given this requirement, Brian concludes that Regulation 1.482-7A is invalid because it is inconsistent with the arm's length standard, which remains the regulatory test for CSAs.[78]

Conversely, Professors Susan Morse and Stephen Shay argue, both in an amicus brief submitted (with other tax professors) in *Altera* and elsewhere, that using only a comparability-based analysis to reallocate is inappropriate and will not clearly reflect entities' distribution of income.[79] They observe that the safe harbor protection of Regulation 1.482-7A is explicitly premised on related entities sharing costs in proportion to their share of the expected benefits.[80] Accordingly, allowing related entities to avoid sharing an obvious cost like stock compensation, simply because an unrelated entity would never ration-

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in Altera, IRS INSIGHTS (July 2019) https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-irsinsights-190708.pdf; PWC, *Ninth Circuit Upholds Cost-Sharing Regulations in* Altera, TAX INSIGHTS (June 17, 2019), https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-altera-ninth-cir-decision.pdf; Walker *supra* note 47; Stu Bassin, *A Second Review of Ninth Circuit Argument in* Altera v. Commissioner, PROCEDURALLY TAXING (Oct. 17, 2017), https://procedurallytaxing.com/a-second-review-of-ninth-circuit-argument-in-altera-v-commissioner/.

[76] Brian *supra* note 2, at 1141-42.

[77] *Id.* at 1141 ("The White Paper stated that, although the commensurate with income standard requires adjustments to reflect changes in income, transfer prices must be determined on the basis of true comparables if they in fact exist."); (quoting Notice 88-123, 1988 IRB LEXIS 3758 at *2).

[78] Brian, *supra* note 2, at 1141.

[79] Harvey Amicus Brief *supra* note 2, at 8; Susan C. Morse & Stephen E. Shay, *The Ninth Circuit Reverses the Tax Court Decision in* Altera, PROCEDURALLY TAXING (July 31, 2018), https://procedurallytaxing.com/the-ninth-circuit-reverses-the-tax-court-decision-in-altera/; Susan C. Morse & Stephen E. Shay, *Treasury on the Right Side of the APA in* Altera, PROCEDURALLY TAXING (July 14, 2016), https://procedurallytaxing.com/treasury-on-the-right-side-of-the-apa-in-altera/.

[80] Harvey, Amicus Brief *supra* note 2, at 18–20.

ally agree to do so, is inconsistent with the statutory purpose of Section 482.[81]

In a separate amicus brief in *Altera* submitted by a separate group of prominent tax law professors, amici argue that the IRS is broadly authorized under Section 482 to reallocate costs to be "commensurate with income."[82] Under this commensurate-with-income authority, amici contend that the IRS can make adjustments without necessarily looking to comparable transactions between unrelated entities.[83] Amici also point to the legislative history of the 1986 Act to show that Congress was very concerned about the absence of comparable arm's length transactions in certain circumstances and thus added "commensurate with income" as an additional source of statutory authority.[84]

2. Recent Analysis of the Arm's Length Standard

Other relevant recent scholarship has focused on the underlying question of *Altera*: what standard must the IRS apply in deciding whether a cost is includible in a CSA.[85] Sienna White argues that the traditional arm's length standard is no longer adequate in an increasingly fast-paced, complex and globalized business climate.[86] White instead proposes a hybrid formula for the apportionment-arm's length approach as a solution to transactions where the traditional arm's length standard would be unsuitable.[87] In contrast to the arm's length

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[81] *Id.* at 18-19 ("To use the uncontrolled transactions in this way would violate the clear reflection of income objective that Congress set forth in the statute . . .").

[82] Alstott, Amicus Brief *supra* note 36, at 8.

[83] *Id.* ("This commensurate-with-income authority looks to the income generated by the intangible property—it does not look to comparable transactions (because they may not exist)").

[84] *Id.* at 15 (citing H.R. Rep. No. 99-426, at 424–25).

[85] *See* Sienna C. White, *Cost Sharing Agreements & the Arm's Length Standard: A Matter of Statutory Interpretation?,* 19 FLA. TAX REV. 191 (2016); Tyler Johnson, Note, *Nobody's Stock Compares to Your Own: How Treasury Can Revive Stock Compensation in Cost-Sharing Agreements,* 111 NW. U. L. REV. 793 (2017).

[86] White *supra* note 85, at 195.

[87] *Id*. at 219 ("[A] hybrid formulary-arm's length system would lead to greater predictability for MNEs, as well as more predictable tax revenue for the government.").

standard, which treats related entities as separate taxpayers, formulary apportionment solves the transfer pricing problem by treating a group of related entities as one firm, allocating its profits among countries using a set formula that would account for a firm's level of payroll, sales and capital located in each country.[88] White's solution is a hybrid: the IRS would utilize the traditional arm's length method for transactions with clearly comparable unrelated transactions, while adopting formulas for those transactions without comparable unrelated transactions,[89] in order to achieve a clearer reflection of corporate income.[90]

Similarly, in a recent note responding to the initial Tax Court opinion in *Altera* invalidating the regulation, Tyler Johnson argues that a strict arm's length standard is not required by Section 482 and instead proposes a solution to curing Regulation 1.482-7A's potential APA violation.[91] In order to satisfy the *State Farm* reasoned decision-making standard, Johnson suggests that the Treasury reenact subsection (d)(2) of Regulation 1.482-7A, this time supported by statistical evidence showing that related taxpayers that exclude stock compensation pay a lower portion of total employee compensation than unrelated taxpayers.[92] Consequently, Johnson asserts, the regulation

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[88] *Id.* at 215–16; *see also* TAX POLICY CENTER, "Briefing Book: How Would Formulary Apportionment Work?" https://www.taxpolicycenter.org/briefing-book/how-would-formulary-apportionment-work.

[89] White *supra* note 85, at 223 ("Rather than maintaining the status quo, the United States should adopt a transfer pricing system that reflects economic reality, but also embodies the *spirit* of section 482—creating parity between taxpayers.") (emphasis in original).

[90] Interestingly, the OECD has recently proposed a new digital tax framework that takes a similar hybrid approach. *See* Organisation for Economic Co-operation and Development [OECD], *Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One*, 5 (Oct. 9, 2019), https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf ("At the same time, the approach largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula based solutions in areas where tensions in the current system are the highest.").

[91] Johnson, *supra* note 85, at 832.

[92] *Id.* at 831. ("[I]f Treasury can demonstrate that controlled taxpayers have paid a lower percentage of total employee compensation as salary than uncontrolled taxpayers, they can show such a rule is necessary for the results of related party transactions to be consistent with the results unrelated parties would reach as required by the arm's length standard.").

would be reasonable and necessary to achieving the statutory goal of preventing tax evasion and achieving tax parity by having unrelated and related entities pay the same portions of employee compensation.[93]

D. Implications

The most obvious takeaway from *Altera* is that multinational corporations will face higher U.S. tax bills, through both their own voluntary compliance and through newly vigorous IRS enforcement.[94] Numerous prominent U.S.-based tech companies have already disclosed significant future financial losses in recent SEC filings as a result of the ruling in *Altera*.[95] Facebook, for example, reported an additional expense of $1.11 billion due to the *Altera* ruling in its latest 10-Q filing.[96] While U.S. corporate tax rates have fallen under the 2017 Tax Cuts & Jobs Act (TCJA), U.S. rates remain comparatively higher than those of other jurisdictions where corporations commonly incorporate subsidiary entities.[97] Accordingly, even under the new corporate rates, *Altera* will still likely lead to higher tax bills for many large companies that allocate costs to foreign subsidiaries. The ability of publicly traded tech companies like Alphabet and Facebook to legally minimize their U.S. federal tax liabilities through transfer pricing is an important source of value for shareholders.[98] Consequently, the *Altera* decision may well have a depressive effect on the market for shares of certain companies, particularly Silicon Valley tech firms, as the IRS gradually begins to ratchet up enforcement. Perennial stock market favorites like Alphabet and Facebook, which rely heavily on

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[93] *Id.* at 832.
[94] Boris, *supra* note 10.
[95] *Id.*
[96] Facebook, Quarterly Rep. (Form 10-Q) at 23–25 (July 25, 2019) ("Based on the *Altera* Ninth Circuit Panel Opinion, we recorded a cumulative income tax expense of $1.11 billion in the second quarter of 2019.").
[97] TAX POLICY CENTER, "Briefing Book: How Did the Tax Cuts and Jobs Act Change Business Taxes?" https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-business-taxes; KPMG, Corporate Tax Rates Table, https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html (last visited Sep. 24, 2019).
[98] *See* Michael Avramovich, Note: *Intercompany Transfer Pricing Regulations under Internal Revenue Code Section 482: The Noose Tightens on Multinational Corporations*, 28 J. MARSHALL L. REV. 915, 929 (1995) ("In order to maximize the value of its business, a multinational company must develop a "network of cash flows" that maximizes shareholder wealth.").

stock-based compensation, may find themselves under market scrutiny.[99]

More broadly, *Altera* opens the door to the IRS taking increasingly aggressive positions on transfer pricing issues. The Ninth Circuit's expansive interpretation of the arm's length standard may well give the IRS a stronger legal foundation in contexts beyond the QCSA regulations.[100] Consequently, many companies now face increasing uncertainty and higher transaction costs in tax planning and transfer pricing.[101] The decision may also have an international effect, as the arm's length standard has been widely adopted abroad as the governing standard for transfer pricing.[102] Foreign government tax authorities may react to the decision in *Altera* by expanding their own interpretations of the arm's length standard, in order to capture more taxable income. This could lead to conflicting tax treatments, double taxation of multinational corporations, and further uncertainty for corporate compliance and planning.[103] An inconsistent global transfer

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[99] Alphabet, Quarterly Rep. (Form 10-Q) at 28 (July 25, 2019) ("Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes."); *see also* Richard Rubin & Theo Francis, *Yearslong Tax Dispute Could Cost Big Tech Companies Billions*, WALL ST. J. (Sep. 3, 2019).

[100] *See* Petitioner-Appellee's Petition for Rehearing En Banc *supra* note 65, at 14 ("The consequences of this reimagining of Section 482 potentially are far-reaching; nothing in the panel's decision limits the "purely internal" standard to stock-based compensation."); Cisco, Amicus Brief *supra* note 67, at 12 ("That will have far-reaching negative consequences—not just in the context of cost sharing, but very possibly in all aspects of transfer pricing.").

[101] *See* Cisco, Amicus Brief *supra* note 67, at 12 (stating that the *Altera* decision created "much uncertainty in a heretofore settled area.").

[102] *See* Brief of Former Foreign Tax Officials as Amici Curiae Supporting Petitioner-Appellee's Petition for Rehearing En Banc at 2–3, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) ("[The *Altera* opinion] is inconsistent with the longstanding application of the arm's length standard enshrined in the tax laws and treaty obligations of many nations, including the United States.").

[103] *See id.* at 10 ("Cross-border tax disputes are time- and resource-intensive not only for taxpayers but also for governments, and uncertainty in the tax law can impede free flow of business activity across borders.") (internal citations omitted); Petitioner-Appellee's Petition for Rehearing En Banc *supra* note 65, at 15 ("If the United States moves away from the settled understanding of [the arm's length] standard, other nations may follow suit, resulting in a patchwork of regulations that subjects companies to double-taxation."); *see also* Allison Christians, *How Nations Share*, 87 IND. L.J. 1407, 1422 n. 67 (2012) (noting

pricing regime could also lead to inter-governmental political conflicts and increasing politicization of cross-border taxation issues.[104]

Despite ruling for the IRS, the Ninth Circuit's reasoning also reflects a significant and ongoing shift in the judicial treatment of tax regulations. Traditionally, courts arguably followed an informal doctrine of "tax exceptionalism," which included deferring to Treasury regulations to a lesser extent than what's found in other areas of administrative law.[105] However, in recent years, since the Supreme Court's decision in *Mayo*,[106] courts have scaled back this unique treatment and subjected Treasury regulations to the conventional *Chevron* analysis prevalent in administrative law.[107] *Altera* represents another prominent instance of a tax regulation being subjected merely to conventional *Chevron* deference.[108] With the current composition of the Supreme Court, the future of *Chevron* and other forms of administrative deference remains unclear.[109] But, in the interim, the Ninth Circuit's

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that IRS reallocations under Treas. Reg. § 1.482-1 can be potential examples of one country's arm's length interpretation leading to double taxation).

[104] Brief of Former Foreign Tax Officials, *supra* note 101, at 10 ("In some cases, unresolved disagreements between countries about taxation can lead to high-level political conflict.").

[105] *See* Lawrence Zelenak, *Maybe Just A Little Bit Special, After All?*, 63 DUKE L.J. 1897, 1898 (2014); Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1539–1541 (2006).

[106] Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 55 (2011) ("[W]e are not inclined to carve out an approach to administrative review good for tax law only.") (holding that *Chevron* deference applied to the Treasury regulation in question).

[107] *See generally* Stephanie R. Hoffer & Christopher J. Walker, *The Death of Tax Court Exceptionalism*, 99 MINN. L. REV. 221 (2014) (examining the history of tax exceptionalism and the *Mayo* case). *But see* Matthew A. Melone, *Light on the* Mayo*: Recent Developments May Diminish the Impact of* Mayo Foundation *on Judicial Deference to Tax Regulations*, 13 HASTINGS BUS. L.J. 149 (2017).

[108] The first, withdrawn opinion notes that the question of tax exceptionalism was not before the court, but the later controlling opinion omits this reference. Altera Corp. v. Comm'r, 2018 U.S. App. LEXIS 20524 at *26 n. 5 (9th Cir. 2018) ("[T]his case does not require us to decide the broader questions of the precise contours of the application of APA to the Commissioner's administration of the tax system or the continued vitality of the theory of tax exceptionalism.").

[109] *See* Kisor v. Wilkie, 139 S. Ct. 2400, 2446 n.114 (2019) (Gorsuch, J. concurring) ("To be sure, under *Chevron* . . . we sometimes defer to an agency's

decision is an indicator of circuit courts' increasing willingness to place Treasury regulations on the same level of *Chevron* deference as other agency regulations.

Even if the Supreme Court declines to grant certiorari in the present case, it may have little choice but to grant a hearing on a similar case in the future. The Ninth Circuit's decision creates a de facto circuit split, as the Tax Court will be bound by the *Altera* decision only when hearing cases from taxpayers within the Ninth Circuit.[110] Given the Tax Court's unanimous ruling for Altera, it is highly unlikely that its judges would be so persuaded by the Ninth Circuit opinion as to voluntarily adopt its precedent going forward.[111] Conversely, the government would almost certainly pursue appeals of any adverse Tax Court rulings to the appellate level. Another circuit court could soon hear a corresponding case on appeal from the Tax Court and rule for a corporate plaintiff, creating a direct circuit conflict that would almost

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construction of a statute. But there are serious questions, too, about whether *that* doctrine comports with the APA and the Constitution.") (emphasis in original).

[110] *See* Golsen v. Comm'r, 54 T.C. 742, 756–57 (1970) (adopting the so-called "*Golsen* rule" in which the Tax Court is only bound by precedent of the circuit in which an appeal would arise in the case at bar). *But see also* Natalie Olivo, *Admin. Law Could Pave Way for High Court Tax Regs Fight*, LAW 360 TAX AUTHORITY (Nov. 15, 2019), https://www.law360.com/tax-authority/articles/1219635/admin-law-could-pave-way-for-high-court-tax-regs-fight (quoting a practitioner who observed that most tech companies affected by *Altera* are located in the Ninth Circuit, which could make such a hypothetical case unlikely).

[111] *See* Petitioner-Appellee's Petition for Rehearing En Banc *supra* note 65, at 20 ("In a case arising in a different Circuit, the Tax Court undoubtedly would apply its unanimous view that the regulation is invalid."). *But see also* Respondent-Appellant's Response in Opposition to Petition for Rehearing En Banc at 12, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) (remarking that at least eight Tax Court judges would be hearing such a theoretical case for the first time and could rule differently); Brief of Law Academics and Professors as Amici Curiae in Opposition to the Petition for Rehearing En Banc at 19, Altera Corp. v. Comm'r, 926 F.3d 1061 (9th Cir. 2019) (No. 16-70497) ("Tax Court internal practice directs that the full Tax Court would review such a case in court conference, and carefully reconsider its prior view in light of the Ninth Circuit's opinion.").

certainly trigger a trip to the Supreme Court—especially given the importance of this issue to some of America's largest corporations.[112]

E. Conclusion

Altera will almost certainly not be the final battle waged over the inclusion of employee stock compensation in a CSA or over the broader issue of the IRS's increasingly expansive interpretation of the arm's length standard. While the long procedural path of *Altera v. Commissioner* may or may not continue, other corporate challengers will soon enter the fray to reassert the primacy of the traditional comparability-based arm's length standard. Such challengers may well echo the arguments made in the briefs, opinions, and articles discussed above. Practitioners and scholars would be well-advised to watch this important issue closely in future months and years. Perhaps a trip to the Supreme Court awaits.

Michael Waalkes[113]

[112] *See, e.g.*, Cisco, Amicus Brief *supra* note 67, at 12 (declaring on behalf of thirty-three large corporations that *Altera* will hurt U.S. corporations' ability to stay competitive in the global market).

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