APPENDICES

APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Altera Corporation & Subsidiaries, *Petitioner-Appellee*, v. Commissioner of Internal Revenue, *Respondent-Appellant*.	Nos. 16-70496 16-70497 Tax Ct. Nos. 6253-12 9963-12 OPINION

Appeal from Decisions of the United States Tax Court

Argued and Submitted October 16, 2018
San Francisco, California

Filed June 7, 2019

Before: Sidney R. Thomas, Chief Judge, and Susan P. Graber* and Kathleen M. O'Malley,** Circuit Judges.

Opinion by Chief Judge Thomas;
Dissent by Judge O'Malley

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* The Honorable Stephen R. Reinhardt was originally assigned to this panel. Following his death, the Honorable Susan P. Graber was drawn by lot to replace him on the panel.

** The Honorable Kathleen M. O'Malley, United States Circuit Judge for the U.S. Court of Appeals for the Federal Circuit, sitting by designation.

SUMMARY***

Tax

The panel reversed a decision of the Tax Court that 26 C.F.R. § 1.482-7A(d)(2), under which related entities must share the cost of employee stock compensation in order for their cost-sharing arrangements to be classified as qualified cost-sharing arrangements, was invalid under the Administrative Procedure Act.

At issue was the validity of the Treasury regulations implementing 26 U.S.C. § 482, which provides for the allocation of income and deductions among related entities. The panel first held that the Commissioner of Internal Revenue did not exceed the authority delegated to him by Congress under 26 U.S.C. § 482. The panel explained that § 482 does not speak directly to whether the Commissioner may require parties to a QCSA to share employee stock compensation costs in order to receive the tax benefits associated with entering into a QCSA. The panel held that the Treasury reasonably interpreted § 482 as an authorization to require internal allocation methods in the QCSA context, provided that the costs and income allocated are proportionate to the economic activity of the related parties, and concluded that the regulations are a reasonable method for achieving the results required by the statute. Accordingly, the regulations were entitled to deference under *Chevron,*

*** This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

The panel next held that the regulations at issue were not arbitrary and capricious under the Administrative Procedure Act.

Dissenting, Judge O'Malley would find, as the Tax Court did, that 26 C.F.R. § 1.482-7A(d)(2) is invalid as arbitrary and capricious.

COUNSEL

Arthur T. Catterall (argued), Richard Farber, and Gilbert S. Rothenberg, Attorneys; Travis A. Greaves, Deputy Assistant Attorney General; Richard E. Zuckerman, Principal Deputy Assistant Attorney General; Tax Division, United States Department of Justice, Washington, D.C.; for Respondent-Appellant.

Donald M. Falk (argued), Mayer Brown LLP, Palo Alto, California; Thomas Kittle-Kamp and William G. McGarrity, Mayer Brown LLP, Chicago, Illinois; Brian D. Netter and Travis Crum, Mayer Brown LLP, Washington, D.C.; A. Duane Webber, Phillip J. Taylor, and Joseph B. Judkins, Baker & McKenzie LLP, Washington, D.C.; for Petitioner-Appellee.

Susan C. Morse, University of Texas School of Law, Austin, Texas; Stephen E. Shay and Allison Bray, Certified Law Students, Harvard Law School, Cambridge, Massachusetts; for Amici Curiae J. Richard Harvey, Reuven Avi-Yonah, Lily Batchelder, Joshua Blank, Noël Cunningham, Victor Fleischer, Ari Glogower, David Kamin, Mitchell Kane, Michael Knoll, Rebecca Kysar, Leandra Lederman, Zachary Liscow, Ruth Mason, Susan Morse, Daniel Shaviro, Stephen Shay, John Steines, David Super, Clinton Wallace, and Bret Wells.

Jonathan E. Taylor, Gupta Wessler PLLC, Washington, D.C.; Clint Wallace, Vanderbilt Hall, New York, New York; for Amici Curiae Anne Alstott, Reuven Avi-Yonah, Lily Batchelder, Joshua Blank, Noel Cunningham, Victor Fleischer, Ari Glogower, David Kamin, Mitchell Kane, Sally Katzen, Edward Kleinbard, Michael Knoll, Rebecca Kysar, Zachary Liscow, Daniel Shaviro, John Steines, David Super, Clint Wallace, and George Yin.

Larissa B. Neumann, Ronald B. Schrotenboer, and Kenneth B. Clark, Fenwick & West LLP, Mountain View, California, for Amicus Curiae Xilinx Inc.

Christopher J. Walker, The Ohio State University Moritz College of Law, Columbus, Ohio; Kate Comerford Todd, Steven P. Lehotsky, and Warren Postman, U.S. Chamber Litigation Center, Washington, D.C.; for Amicus Curiae Chamber of Commerce of the United States of America.

John I. Forry, San Diego, California, for Amicus Curiae TechNet.

Alice E. Loughran, Michael C. Durst, and Charles G. Cole, Steptoe & Johnson LLP, Washington, D.C.; Bennett Evan Cooper, Steptoe & Johnson LLP, Phoenix, Arizona; for Amici Curiae Software and Information Industry Association, Financial Executives International, Information Technology Industry Council, Silicon Valley Tax Directors Group, Software Finance and Tax Executives Counsel, National Association of Manufacturers, American Chemistry Council, BSA |

the Software Alliance, National Foreign Trade Council, Biotechnology Innovation Organization, Computing Technology Industry Association, The Tax Council, United States Council for International Business, Semiconductor Industry Association.

Kenneth P. Herzinger and Eric C. Wall, Orrick Herrington & Sutcliffe LLP, San Francisco, California; Peter J. Connors, Orrick Herrington & Sutcliffe LLP, New York, New York; for Amici Curiae Charles W. Calomiris, Kevin H. Hassett, and Sanjay Unni.

Roderick K. Donnelly and Neal A. Gordon, Morgan Lewis & Bockius LLP, Palo Alto, California; Thomas M. Peterson, Morgan Lewis & Bockius LLP, San Francisco, California; for Amicus Curiae Cisco Systems Inc.

Christopher Bowers, David Foster, Raj Madan, and Royce Tidwell, Skadden Arps Slate Meagher & Flom LLP, Washington, D.C.; Nathaniel Carden, Skadden Arps Slate Meagher & Flom LLP, Chicago, Illinois; for Amicus Curiae Amazon.com Inc.

OPINION

THOMAS, Chief Judge:

This appeal presents the question of the validity of 26 C.F.R. § 1.482-7A(d)(2),[1] under which related business entities must share the cost of employee stock

[1] The 2003 amendments are at issue. Although they are still in effect, the Tax Code has been reorganized, and what was

compensation in order for their cost-sharing arrangements to be classified as qualified cost-sharing arrangements ("QCSA"). Although the case appears complex, the dispute between the Department of the Treasury and the taxpayer is relatively straightforward. The parties agree that, under the governing tax statute, the "arm's length" standard applies; but they disagree about how the standard may be met. The taxpayer argues that Treasury must employ a specific method to meet the arm's length standard: a comparability analysis using comparable transactions between unrelated business entities. Treasury disagrees that the arm's length standard requires the specific comparability *method* in all cases. Instead, the standard generally requires that Treasury reach an arm's length *result* of tax parity between controlled and uncontrolled business entities. With respect to the transactions at issue here, the governing statute allows Treasury to apply a purely internal method of allocation, distributing the costs of employee stock options in proportion to the income enjoyed by each related taxpayer.

Our task, of course, is not to assess the better tax policy, nor the wisdom of either approach, but rather to examine whether Treasury's regulations are permitted under the statute. Applying the familiar tools used to examine administrative agency regulations, we conclude that the regulations withstand scrutiny. Therefore, we reverse the judgment of the Tax Court.

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§ 1.482-7 in 2003 is now numbered § 1.482-7A. To minimize confusion, our citations are to the current version of the regulation unless otherwise specified.

I

For many years, Congress and the Treasury have been concerned with American businesses avoiding taxes through the creation and use of related business entities. In the last several decades, Congress has directed particular attention to the potential for tax abuse by multinational corporations with foreign subsidiaries. If, for example, the parent business entity is in a high-tax jurisdiction, and the foreign subsidiary is in a low-tax jurisdiction, the business enterprise can shift costs and revenue between the related entities so that more taxable income is allocated to the lower tax jurisdiction. Similarly, a parent and foreign subsidiary can enter into significant tax-avoiding cost sharing arrangements.

This potential for tax abuse is generally not present when similar transactions occur between unrelated business entities. In those instances, each separate unrelated entity has the incentive to maximize profit, and thus to allocate costs and income consistent with economic realities. However, among related parties, those incentives do not exist. Rather, among related parties, after-tax maximization of profit may depend on how costs and income are allocated between the parent and the subsidiary regardless of economic reality, given that after-tax profits are commonly shared.

The concern about tax avoidance through the use of related business entities is not new. In the Revenue Act of 1928, Congress granted the Secretary of the Treasury the authority to reallocate the reported income and costs of related businesses "in order to prevent evasion of taxes or clearly to reflect the income of any such trades or businesses." Revenue Act of 1928, ch. 852, § 45, 45 Stat. 791, 806. This statute was designed to give Treasury the flexibility it needed to prevent transaction-shuffling between related entities for the purpose of decreasing tax liability. *See* H.R. Rep. No. 70-2, at 16-17 (1927) ("[T]he Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability."); *accord* S. Rep. No. 70-960, at 24 (1928). The purpose of the statute was "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer." *Comm'r v. First Sec. Bank of Utah*, 405 U.S. 394, 400 (1972) (quoting 26 C.F.R. § 1.482-1(b)(1) (1971)). In short, the primary aim of the statute was to prevent tax evasion by related business taxpayers.[2]

In 1934, the Commissioner adopted regulations implementing the statute and first adopted the familiar "arm's length" standard: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. 86, art. 45-1(b) (1935). In the context of a controlled transaction, the arm's length standard is satisfied "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)." 26 C.F.R. § 1.482-1(b)(1). The

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[2] An important, but secondary purpose was to avoid double taxation of multi-national corporations, which the United States effected through various tax treaties. *See, e.g.*, Convention Concerning Double Taxation, Fr.-U.S., art. IV, Apr. 27, 1932, 49 Stat. 3145.

relevant regulation also noted: "However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances." *Id.*

Although the Secretary adopted the arm's length standard, courts did not hold related parties to that standard by exclusively requiring the examination of comparable transactions. For example, in *Seminole Flavor Co. v. Commissioner*, the Tax Court rejected a strict application of the arm's length standard in favor of an inquiry into whether the allocation of income between related parties was "fair and reasonable." 4 T.C. 1215, 1232 (1945); *see also id.* at 1233 ("Whether any such business agreement would have been entered into by petitioner with total strangers is wholly problematical."); *Grenada Indus., Inc. v. Comm'r*, 17 T.C. 231, 260 (1951) ("We approve an allocation . . . to the extent that such gross income in fact exceeded the fair value of the services rendered . . . ."). And in 1962, we collected various allocation standards and outright rejected the superiority of the arm's length bargaining analysis over all others:

> [W]e do not agree . . . that "arm's length bargaining" is the sole criterion for applying the statutory language of [26 U.S.C. § 482] in determining what the "true net income" is of each "controlled taxpayer." Many decisions have been reached under [§ 482] without reference to the phrase "arm's length bargaining" and without reference to Treasury Department Regulations and Rulings which state that the talismanic combination of words – "arm's length" – is the "standard to be applied in every case."

Frank v. Int'l Canadian Corp., 308 F.2d 520, 528-29 (9th Cir. 1962).

Frank noted that "it was not any less proper . . . to use here the 'reasonable return' standard than it was for other courts to use 'full fair value,' 'fair price including a reasonable profit,' 'method which seems not unreasonable,' 'fair consideration which reflects arm's length dealing,' 'fair and reasonable,' 'fair and reasonable' or 'fair and fairly arrived at,' or 'judged as to fairness,' all used in interpreting [the statute]." *Id.* (footnotes omitted). We later limited *Frank* to situations in which "it would have been difficult for the court to hypothesize an arm's-length transaction." *Oil Base, Inc. v. Comm'r*, 362 F.2d 212, 214 n.5 (9th Cir. 1966). However, *Frank's* central point remained: the arm's length standard based on comparable transactions was not the *sole* basis of reallocating costs and income under the statute.

In the 1960s, the problem of abusive transfer pricing practices created a new adherence to a stricter arm's length standard. In response to concerns about the undertaxation of multinational business entities, Congress considered reworking the Tax Code to resolve the difficulty posed by the application of the arm's length standard to related party transactions. H.R. Rep. No. 87-1447, at 28-30 (1962). However, it instead asked Treasury to "explore the possibility of developing and promulgating regulations . . . which would provide additional guidelines and formulas for the allocation of income and deductions" under 26 U.S.C. § 482. H.R. Rep. No. 87-2508, at 19 (1962) (Conf. Rep.), *as reprinted in* 1962 U.S.C.C.A.N. 3732, 3739. Legislators believed that § 482 authorized the Secretary to employ a profit-split allocation method without amendment. *Id.*; H.R. Rep. No. 87-1447, at

28-29. In 1968, following Congress's entreaty, Treasury finalized the first regulation tailored to the issue of intangible property development in QCSAs. 26 C.F.R. § 1.482-2(d) (1968).

The 1968 regulations "constituted a radical and unprecedented approach to the problem they addressed – notwithstanding their being couched in terms of the 'arm's length standard,' and notwithstanding that that standard had been the nominal standard under the regulations for some 30 years." Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 644 (1986). In addition to three arm's length pricing methods, the 1968 regulations included a "fourth method," which was essentially open-ended: "Where none of the three methods of pricing . . . can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described . . . , or variations on such methods, can be used." 26 C.F.R. § 1.482-2(e)(1)(iii) (1968).

Following the promulgation of the 1968 regulation, courts continued to employ a comparability analysis, but not to the exclusion of other methodologies. Reuven S. Avi-Yonah, *The Rise & Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 Va. Tax Rev. 89, 108-29 (1995). Indeed, a study determined that direct comparable transactions were located and applied in only 3% of the Internal Revenue Service's adjustments prior to the 1986 amendment. U.S. Gen. Accounting Office., GGD-81-81, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (1981). The decades following the 1968 regulations involved

> a gradual realization by all parties concerned, but especially Congress and the IRS, that the [compa-

> rability method of meeting the arm's length standard], firmly established . . . as the sole standard under section 482, did not work in a large number of cases, and in other cases its misguided application produced inappropriate results. The result was a deliberate decision to retreat from the standard while still paying lip service to it.

Avi-Yonah, *supra*, at 112; *see also* James P. Fuller, *Section 482: Revisited Again*, 45 Tax L. Rev. 421, 453 (1990) ("[T]he 1986 Act's commensurate with income standard is not really a new approach to § 482.").

Ultimately, as controlled transactions increased in frequency and complexity, particularly with respect to intangible property, Congress determined that legislative action was necessary. The Tax Reform Act of 1986 reflected Congress's view that strict adherence to the comparability method of meeting the arm's length standard prevented tax parity. Thus, the Tax Reform Act of 1986 added a sentence to § 482 that largely forms the basis of the present dispute, providing that:

> In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Tax Reform Act of 1986, 26 U.S.C. § 482 (1986) (as amended 2018).

The House Ways and Means Committee recommended the addition of the commensurate with income clause because it was "concerned" that the current code and regulations "may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles." H.R. Rep. No. 99-426, at 423 (1985). The clause was intended to correct a "recurrent problem" – "the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables." *Id*. at 423-24.

The House Report makes clear that the committee intended the commensurate with income standard to displace a comparability analysis where comparable transactions cannot be found:

> A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. . . . [M]ultinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries . . . .
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> . . . .
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> Certain judicial interpretations of section 482 suggest that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. While the committee is concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believes that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles is necessary.
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> . . . .

> . . . There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation . . . be commensurate with the income attributable to the intangible . . . .
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> . . . .
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> . . . [T]he committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangible transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms.

Id. at 424-25 (footnote and citation omitted).[3]

Treasury's first response to the Tax Reform Act was the "White Paper," an intensive study published in 1988. *A Study of Intercompany Pricing Under Section 482 of the Code,* I.R.S. Notice 88-123, 1988-2 C.B. 458 ("White Paper"). The White Paper confirmed that

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[3] The Conference Committee suggested only one change – to broaden the sweep of the amendment so as to encompass domestic related-party transactions – in order to better serve the objective of the amendment, "that the division of income between related parties reasonably reflect the relative economic activity undertaken by each." H.R. Rep. No. 99-841, at II-637 (1986) (Conf. Rep.), *as reprinted in* 1986 U.S.C.C.A.N. 4075, 4725. The Report also clarified that cost-sharing arrangements would not generally be subject to § 482 allocations – but only "if and to the extent . . . the income allocated among the parties reasonably reflect the actual economic activity undertaken by each." *Id.* at II-638.

Treasury believed the commensurate with income standard to be consistent with the arm's length standard (and that Treasury understood Congress to share that understanding). *Id*. at 475. Treasury wrote that a comparability analysis must be performed where possible, *id*. at 474, but it also suggested a "clear and convincing evidence" standard for comparable transactions, indicating that a comparability analysis would rarely be possible. *Id*. at 478.

The White Paper signaled a shift in the interpretation of the arm's length standard as it had been defined following the 1968 regulations. Treasury advanced a new allocation method, the "basic arm's length return method," White Paper at 488, that would apply only in the absence of comparable transactions and would essentially split profits between the related parties, *id*. at 490. Commentators understood that, by attempting to synthesize the arm's length standard and the commensurate with income provision, Treasury was moving away from a view that the arm's length standard always requires a comparability analysis. Marc M. Levey, Stanley C. Ruchelman, & William R. Seto, *Transfer Pricing of Intangibles After the Section 482 White Paper*, 71 J. Tax'n 38, 38 (1989); Josh O. Ungerman, Comment, *The White Paper: The Stealth Bomber of the Section 482 Arsenal*, 42 Sw. L.J. 1107, 1128-29 (1989).

In 1994 and 1995, Treasury issued new regulations that defined the arm's length standard as result-oriented, meaning that the goal is parity in *taxable income* rather than parity in the method of allocation itself. 26 C.F.R. § 1.482-1(b)(1) (1994) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."). However, the arm's length standard remained "the standard to be applied in every case." *Id.*

The regulations also set forth methods by which income could be allocated among related parties in a manner consistent with the arm's length standard. *Id.* § 1.482-1(b)(2)(i) (1994). According to Treasury, the 1994 regulations defined the arm's length standard in terms of "the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Compensatory Stock Options Under Section 482, 67 Fed. Reg. 48,997-01, 48,998 (proposed July 29, 2002).

The 1995 regulation provided that "[i]ntangible development costs" included "all of the costs incurred by [a controlled] participant related to the intangible development area." 26 C.F.R. § 1.482-7(d)(1) (1995). By contrast to the 1994 regulation, the 1995 regulation – consistent with the 1986 Conference Report – "implement[ed] the commensurate with income standard in the context of cost sharing arrangements" by "requir[ing] that controlled participants in a [QCSA] share all costs incurred that are related to the development of intangibles in proportion to their shares of the reasonably anticipated benefits attributable to that development." Compensatory Stock Options Under Section 482, 67 Fed. Reg. at 48,998.

Neither the Tax Reform Act nor the implementing regulations specifically addressed allocation of employee stock compensation, which is the issue in this dispute. However, that omission was unsurprising given that the practice did not develop on a major scale until the 1990s. Zvi Bodie, Robert S. Kaplan, & Robert C. Merton, *For the Last Time: Stock Options Are an Expense*, Harv. Bus. Rev., Mar. 2003, at 62, 67. Beginning in 1997, the Secretary interpreted the "all . . . costs" language to include stock-based compensation, meaning that controlled taxpayers had to share the costs (and associated deductions) of providing employee stock compensation. *Xilinx, Inc. v. Comm'r*, 598 F.3d 1191, 1193-94 (9th Cir. 2010).

In 2003, Treasury issued the cost-sharing regulations that are challenged in this case. Treasury intended for the 2003 amendments to clarify, rather than to overhaul, the 1994 and 1995 regulations. The clarifications were twofold. First, the amendments directly classified employee stock compensation as a cost to be allocated between QCSA participants. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 48,998; 26 C.F.R. § 1.482-7A(d)(2). Second, the "coordinating amendments" clarified Treasury's belief that the cost-sharing regulations, including § 1.482-7A(d)(2), operate to produce an arm's length result. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 48,998; 26 C.F.R. § 1.482-7A(a)(3).

Specifically, § 1.482-7A provides that costs shared by related parties to a QCSA are not subject to IRS reallocation for tax purposes if each entity's share of the intangible property development costs equals each entity's reasonably anticipated benefits. Section 1.482-7A(a)(3) incorporates and coordinates with the arm's length standard:

> A qualified cost sharing arrangement produces results that are consistent with an arm's length result . . . if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development . . . .

Section 1.482-7A(d)(2) provides that parties to a QCSA must allocate stock-based compensation between themselves:

> [In a QCSA], a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

These regulations, and the procedure employed in adopting them, form the basis of the present controversy.

II

At issue is Altera Corporation ("Altera") & Subsidiaries' tax liability for the years 2004 through 2006. During the relevant period, Altera and its subsidiaries designed, manufactured, marketed, and sold programmable logic devices, which are electronic components that are used to build circuits.

In May of 1997, Altera entered into a cost-sharing agreement with one of its foreign subsidiaries, Altera International, Inc., a Cayman Islands corporation ("Altera International"), which had been incorporated earlier that year. Altera granted to Altera International a license to use and exploit Altera's preexisting intangible property everywhere in the world except the United States and Canada. In exchange, Altera

International paid royalties to Altera. The parties agreed to pool their resources to share research and development ("R&D") costs in proportion to the benefits anticipated from new technologies. The question in this appeal is whether Treasury was permitted, for tax liability purposes, to re-allocate the cost of employee stock-based compensation.

Altera and the IRS agreed to an Advance Pricing Agreement covering the 1997-2003 tax years. Pursuant to this agreement, Altera shared with Altera International stock-based compensation costs as part of the shared R&D costs. After the Treasury regulations were amended in 2003, Altera and Altera International amended their cost-sharing agreement to comply with the modified regulations, continuing to share employee stock compensation costs.

The agreement was amended again in 2005 following the Tax Court's opinion in *Xilinx Inc. & Consolidated Subsidiaries v. Commissioner*, which involved a challenge to the 1994-1995 cost-sharing regulations. 125 T.C. 37 (2005). The parties agreed to "suspend the payment of any portion of [a] Cost Share . . . to the extent such payment relates to the Inclusion of Stock-Based Compensation in R&D Costs" unless and until a court upheld the validity of the 2003 cost-sharing regulations. The following provision explains Altera's reasoning:

> The Parties believe that it is more likely than not that (i) the Tax Court's conclusion in *Xilinx v. Commissione*r, 125 T.C. [No.] 4 (2005), that the arm's length standard controls the determination of costs to be shared by controlled participants in a qualified cost sharing arrangement should also apply to Treas. Reg. § 1.482-7(d)(2) (as amended by T.D. 9088), and (ii) the Parties' inclusion of Stock-Based Compensation in R&D Costs pursuant to

Amendment I would be contrary to the arm's length standard.

Altera and its U.S. subsidiaries did not account for R&D-related stock-based compensation costs on their consolidated 2004-2007 federal income tax returns. The IRS issued two notices of deficiency to the group, applying § 1.482-7(d)(2) to increase the group's income by the following amounts:

2004	$ 24,549,315
2005	$ 23,015,453
2006	$ 17,365,388
2007	$ 15,463,565

Altera timely filed petitions in the Tax Court. The parties filed cross-motions for summary judgment, and the Tax Court granted Altera's motion. Sitting en banc, the Tax Court held that § 1.482-7A(d)(2) is invalid under the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701-706. *Altera Corp. & Subsidiaries v. Comm'r*, 145 T.C. 91 (2015).

The Tax Court unanimously determined: (1) that the Commissioner's allocation of income and expenses between related entities must be consistent with the arm's length standard; and (2) that the arm's length standard is not met unless the Commissioner's allocation can be compared to an actual transaction between unrelated entities. The Tax Court reasoned that the Commissioner could not require related parties to share stock compensation costs, because the Commissioner had not considered any unrelated party transactions in which the parties shared such costs. The Tax Court held that the agency's decisionmaking process was fundamentally flawed because: (1) it rested on speculation rather than on hard data and expert opinions; and (2) it failed to respond to significant public comments, particularly those pointing out uncontrolled cost-sharing arrangements in which the entities did not share stock compensation costs. *Id.* at 133-34.

The Tax Court's decision rested largely on its own opinion in *Xilinx*, in which it determined that the arm's length standard mandates a comparability analysis. *Id.* at 118 (citing *Xilinx*, 125 T.C. at 53-55). In its decision in this case, as well, the Tax Court suggested that the Commissioner cannot require related entities to share stock compensation costs unless and until the Commissioner locates uncontrolled transactions in which these costs are shared. *Id.* at 118-19.

The Tax Court reached five holdings: (1) the 2003 amendments constitute a final legislative rule subject to the requirements of the APA; (2) *Motor Vehicle Manufacturers Ass'n of the United States, Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983), provides the appropriate standard of review because the standard set forth in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), incorporates *State Farm*'s "reasoned decisionmaking" standard; (3) Treasury did not support adequately its decision to allocate the costs of employee stock compensation between related parties; (4) Treasury's procedural regulatory deficiencies were not harmless;[4] and (5) § 1.482-7A(d)(2) is invalid under the APA.

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[4] On appeal, the Commissioner does not claim that any error in the decisionmaking process, if it existed, was harmless. Thus, we decline to address the issue.

III

Our task in this appeal, then, is to determine whether Treasury's 2003 regulations are lawful. In the context of the arguments made in this case, we evaluate the validity of the agency's regulations under both *Chevron* and *State Farm*, which "provide for related but distinct standards for reviewing rules promulgated by administrative agencies." *Catskill Mountains Chapter of Trout Unlimited, Inc. v. EPA*, 846 F.3d 492, 521 (2d Cir. 2017). "*State Farm* is used to evaluate whether a rule is procedurally defective as a result of flaws in the agency's decisionmaking process." *Id*. "*Chevron*, by contrast, is generally used to evaluate whether the conclusion reached as a result of that process – an agency's interpretation of a statutory provision it administers – is reasonable." *Id*.[5] "A litigant challenging a rule may challenge it under *State Farm*, *Chevron*, or both." *Id*. Altera challenges both the procedural adequacy of the APA process and the substance of the regulation.[6]

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[5] There are circumstances when the two analyses may overlap. *See, e.g.*, *Confederated Tribes of Grand Ronde Cmty. of Or. v. Jewell*, 830 F.3d 552, 561 (D.C. Cir. 2016) (We are mindful that, "[i]n [some] situations, what is 'permissible' under *Chevron* is also reasonable under *State Farm*." (quoting *Arent v. Shalala*, 70 F.3d 610, 616 n.6 (D.C. Cir. 1995))).

[6] We afforded the parties the opportunity to file optional supplemental briefs on the question whether the six-year statute of limitations under 28 U.S.C. § 2401(a) – which generally applies to procedural challenges to regulations under the APA – applies to this case. The Commissioner responded that it had waived this non-jurisdictional defense by failing to assert it to the Tax Court. We agree with the parties that the Commissioner waived the defense. *Day v. McDonough*, 547 U.S. 198, 210 n.11 (2006) ("[S]hould a State intelligently choose to waive a statute of limitations defense, a district court would not be at liberty to disregard that choice."); *Whidbee v. Pierce County*, 857 F.3d 1019,

A

We first turn to *Chevron* analysis.

1

Under *Chevron*, we first apply the traditional rules of statutory construction to determine whether "Congress has directly spoken to the precise question at issue." 467 U.S. at 842. We start with the plain statutory text and, "when deciding whether the language is plain, we must read the words 'in their context and with a view to their place in the overall statutory scheme.'" *King v. Burwell*, 135 S. Ct. 2480, 2489 (2015) (quoting *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000)).

In addition, we examine the legislative history, the statutory structure, and "other traditional aids of statutory interpretation" in order to ascertain congressional intent. *Middlesex Cty. Sewerage Auth. v. Nat'l Sea Clammers Ass'n*, 453 U.S. 1, 13 (1981). If, after conducting that *Chevron* step one examination, we conclude that the statute is silent or ambiguous on the issue, we then defer to the agency's interpretation so long as it "is based on a permissible construction of the statute." *Chevron*, 467 U.S. at 843. A permissible construction is one that is not "arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844.

Ultimately, questions of deference boil down to whether "it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority." *United States v. Mead Corp.*, 533 U.S. 218,

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1024 (9th Cir. 2017) ("[E]ven if a claim has expired under a state statute of limitations, a defendant can still waive this affirmative defense."). Therefore, we need not address it.

226-27 (2001). "When Congress has 'explicitly left a gap for an agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,' and any ensuing regulation is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." *Id.* at 227 (quoting *Chevron*, 467 U.S. at 843-44).

Here, the resolution of our step one *Chevron* examination is straightforward. Section 482 does not speak directly to whether the Commissioner may require parties to a QCSA to share employee stock compensation costs in order to receive the tax benefits associated with entering into a QCSA. Thus, there is no question that the statute remains ambiguous regarding the method by which Treasury is to make allocations based on stock-based compensation.

Altera argues that the statute, by its terms, cannot apply to stock-based compensation. According to Altera, stock-based compensation is not "transferred" between parties because only preexisting intangibles can be transferred. Thus, for Altera, Treasury has exceeded the delegation of authority apparent from the plain text of the statute.

We are not persuaded. When parties enter into a QCSA, they are *transferring* future distribution rights to intangibles, albeit intangibles that have yet to be developed. Indeed, the present-day transfer of those rights provides the main incentive for entering into a QCSA. The right to distribute intangibles to be developed later is, itself, one right in the bundle of property rights that exists at the time that parties enter into a QCSA.

Moreover, even assuming that the crucial transfer does not occur contemporaneously, § 482 applies "[i]n the case of *any* transfer . . . of intangible property" that produces income. (Emphasis added.) That phrasing is as broad as possible, and it cannot reasonably be read to exclude the transfers of expected intangible property. *See, e.g.*, *United States v. Gonzales*, 520 U.S. 1, 5 (1997) ("Read naturally, the word 'any' has an expansive meaning . . . ."); *see also Republic of Iraq v. Beaty*, 556 U.S. 848, 856 (2009) ("Of course the word 'any' (in the phrase 'any other provision of law') has an 'expansive meaning, giving us no warrant to limit the class of provisions of law [encompassed by the statutory provision]." (citation omitted)). Additionally, the sentence necessarily is forward-looking because the production of taxable income always follows the transfer.

In short, the text of the statute does not limit its application to preexisting intangibles in the way Altera's argument suggests. Because parties to a QCSA transfer cost-shared intangibles – including stock-based compensation – they are subject to regulation under 26 U.S.C. § 482.

2

Thus, we must move on to *Chevron* step two to consider whether Treasury's interpretation of § 482 as to allocation of employee stock option costs is permissible. An agency's interpretation of statutory authority is examined "in light of the statute's text, structure and purpose." *Miguel-Miguel v. Gonzales*, 500 F.3d 941, 949 (9th Cir. 2007). The interpretation fails if it is "unmoored from the purposes and concerns" of the underlying statutory regime. *Judulang v. Holder*, 565 U.S. 42, 64 (2011). Thus, Congress's purpose in enacting and amending § 482 in 1986 is key to resolution of this issue.

The congressional purpose in enacting § 482 was to establish tax parity. *First Sec. Bank of Utah*, 405 U.S. at 400. In the 1986 amendments, Congress called for an approach to allocation of costs and income that would "reasonably reflect the actual economic activity undertaken by each [party to a QCSA]," H.R. Rep. No. 99-841, at II-638 (1986) (Conf. Rep.). Put another way, Congress's objective in amending § 482 was to ensure that income follows economic activity. *Id.* at II-637. Although the 1986 amendment delegates to Treasury the choice of a specific methodology to achieve that end, it suggested: "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." This standard is a purely internal one, that is, internal to the entity being taxed, and evidence supports Treasury's belief that Congress intended it to be. H.R. Rep. No. 99-426, at 423-35; H.R. Rep. No. 99-841, at II-637 (Conf. Rep.). In the QCSA context, Congress did not want to interfere with controlled cost-sharing arrangements, but only to the degree that the allocation of costs and income "reasonably reflect[s] the actual economic activity undertaken by each." H.R. Rep. No. 99-841, at II-638 (Conf. Rep.). In light of this history, Treasury's decision to adopt a methodology that followed actual economic activity was reasonable.

So was Treasury's determination that uncontrolled cost-sharing arrangements do not provide helpful guidance regarding allocations of employee stock compensation. When it amended § 482 in 1986, Congress bemoaned the difficulties associated with finding and using data involving high-profit intangibles. *See* H.R. Rep. No. 99-426, at 425 ("There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. . . . [I]t is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation be commensurate with the income attributable to the intangible."); *see also* Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171-02, 51,173 (Aug. 26, 2003) (citing H.R. Rep. No. 99-426, at 423-25) ("As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles.").[7] It follows that Congress granted Treasury authority to develop methods that did not rely on analysis of these problematic comparable transactions. Indeed, Treasury echoed Congress's rationale for amending § 482 in the first place when it published

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[7] Although the 2017 amendment to § 482 has no bearing on our analysis, we note that Congress has not changed its mind:

> The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result . . . . The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties . . . .
>
> . . . For income from intangible property, section 482 provides "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property – including, in particular, high-profit-potential intangibles.

H. Rep. No. 115-466, at 574-75 (2017).

the final rule. *Id*. at 51,173 ("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.").

What is more, although Altera suggests there can be only one understanding of the methodology required by the arm's length standard, historically the definition of the arm's length standard has been a more fluid one. Indeed, as we have discussed, for most of the twentieth century the arm's length standard explicitly permitted the use of flexible methodology in order to achieve an arm's length *result*. *See also* H.R. Rep. No. 87-2508, at 18-19 (1962) (Conf. Rep.) (noting that, in 1962, Congress stated that Treasury should "provide additional guidelines and formulas" to achieve arm's length results). It is true that, more recently, an understanding that the primary means of reaching an arm's length result suggested the analysis of comparable transactions. But, in the lead-up to the 1986 amendments, Congress voiced numerous concerns regarding reliance on this methodology. Further, as we have discussed, courts for more than half a century have held that a comparable transaction analysis was not the exclusive methodology to be employed under the statute. In light of the historic versatility of methodology, it is reasonable that Treasury would understand that Congress intended for it to depart from analysis of comparable transactions as the exclusive means of achieving an arm's length result.

In addition, Treasury reasonably concluded that doing away with analysis of comparable transactions was an efficient means of ensuring that § 482 would "operat[e] to assure adequate allocations to the U.S.

taxable entity of income attributable to intangibles in [QCSAs]." H.R. Rep. No. 99-426, at 423. Congress expressed numerous concerns that pre-1986 allocation methods permitted entities to undervalue their tax liability by placing undue emphasis on "the concept of comparables" and basing allocations on industry norms, rather than on actual economic activity. *Id.* at 424-25. Doing away with analysis of comparable transactions, and instead requiring an internal method of allocation, proves a reasonable method of alleviating these concerns.

In sum, Treasury reasonably understood § 482 as an authorization to require internal allocation methods in the QCSA context, provided that the costs and income allocated are proportionate to the economic activity of the related parties. These internal allocation methods are reasonable methods for reaching the arm's length results required by statute. While interpreting the statute to do away with reliance on comparables may not have been "the only possible interpretation" of Congress's intent, it proves a reasonable one. *Entergy Corp. v. Riverkeeper, Inc.*, 556 U.S. 208, 218 (2009). Thus, Treasury's interpretation is not "arbitrary, capricious, or manifestly contrary to the statute," and it is therefore permissible under *Chevron*. 467 U.S. at 844.

3

Altera contends that the Commissioner misreads § 482 and its history, arguing that the addition of the commensurate with income standard to § 482 did nothing to change the meaning and operation of the arm's length standard, thus rendering Treasury's interpretation unreasonable. Altera supports its argument with a canon of construction: "Amendments by implication, like repeals by implication, are not favored." *United States v. Welden*, 377 U.S. 95, 103 n.12 (1964). That canon does not apply here. It operates to prevent courts from attributing unspoken motives to legislators, not to force courts to ignore legislative action and express legislative history. In addition, cases invoking the maxim typically refer to a later-enacted, *separate* statute or provision amending a previous statute or provision; most cases do not involve changes to the same statute or provision.[8] It is illogical to argue that amending a singular statute does not alter its meaning.

Altera's interpretation of the 1986 amendment would render the commensurate with income clause meaningless except in two circumstances: (1) to allow the Commissioner periodically to adjust prices initially assigned following a comparability analysis; and (2) to reflect a party's contribution of existing intangible property or "buy-in" to a cost-sharing arrangement. This narrow reading of § 482 is not supported by the text or history of the 1986 amendment.

The Commissioner's allocation of employee stock compensation costs between related parties is necessary for Treasury to fulfill its obligation under § 482. Congress did not intend to interfere with qualified cost-sharing arrangements when those arrangements provided for the allocation of income consistent with

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[8] *See*, *e.g.*, *Nat'l Ass'n of Home Builders v. Defs. of Wildlife*, 551 U.S. 644, 650-52, 664 n.8 (2007) (considering whether a later-enacted provision of the Endangered Species Act could amend a provision of the Clean Water Act); *Blanchette v. Conn. Gen. Ins. Corps.*, 419 U.S. 102, 134 (1974) (considering whether the Rail Act amended a remedy provided by the Tucker Act); *United States v. Dahl,* 314 F.3d 976, 977-78 (9th Cir. 2002) (considering whether a provision codified as a separate note to an existing statute amended the statute).

the commensurate with income provision. H.R. Rep. No. 99-841, at II-638 (Conf. Rep.).

4

Altera makes much of the United States's treaty obligations with other countries, asserting that a purely internal standard is inconsistent with the standards agreed to therein and is therefore unreasonable. However, there is no evidence that our treaty obligations bind us to the analysis of comparable transactions. As demonstrated by nearly a century of interpreting § 482 and its precursor, the arm's length standard is not necessarily confined to one methodology. It reflects neither how related parties behave nor how they are taxed. Moreover, our most recent treaties incorporate not only the arm's length standard, but also the 2003 regulations. *See, e.g.*, U.S. Dep't of Treasury, Technical Explanation of the Convention Between the United States and Poland for the Avoidance of Double Taxation 31 (2013) ("It is understood that the Code section 482 'commensurate with income' standard for determining appropriate transfer prices for intangibles operates consistently with the arm's-length standard. The implementation of this standard in the regulations under Code section 482 is in accordance with the general principles of paragraph 1 of Article 9 of the Convention . . . .").

B

Though Treasury's interpretation of its statutory grant of authority was reasonable, we also must examine whether the procedures used in its promulgation prove defective under the APA. *Catskill Mountains*, 846 F.3d at 522 ("[I]f an interpretive rule was promulgated in a procedurally defective manner, it will be set aside regardless of whether its interpretation of the statute is reasonable."). After reviewing the administrative record, we conclude that Treasury complied with the procedural requirements of the APA and, therefore, the regulations survive *State Farm* scrutiny.

Section 706 of the APA directs courts to "decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action." 5 U.S.C. § 706 (flush language). Agencies may not act in ways that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Id.* § 706(2)(A).

The APA "sets forth the full extent of judicial authority to review executive agency action for procedural correctness." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 513 (2009). It "prescribes a three-step procedure for so-called 'notice-and-comment rule-making.'" *Perez v. Mortg. Bankers Ass'n*, 135 S. Ct. 1199, 1203 (2015) (citing 5 U.S.C. § 553). First, a "[g]eneral notice of proposed rule making" must ordinarily be published in the Federal Register. 5 U.S.C. § 553(b). Second, provided that "notice [is] required," the agency must "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments." *Id.* § 553(c). "An agency must consider and respond to significant comments received during the period for public comment." *Perez*, 135 S. Ct. at 1203. Third, the agency must incorporate in the final rule "a concise general statement of [its] basis and purpose." 5 U.S.C. § 553(c).

Altera does not dispute that Treasury satisfied the first step by giving notice of the 2003 regulations. *Id.* Nor does there appear to be a controversy as to whether Treasury included in the final rule "a concise general statement of [its] basis and purpose." *Id.*;

5 U.S.C. § 553. Rather, Altera argues that the regulations fail on the second step, asserting that: (1) Treasury improperly rejected comments submitted in opposition to the proposed rule, (2) Treasury's current litigation position is inconsistent with statements made during the rulemaking process, (3) Treasury did not adequately support its position that employee stock compensation is a cost, and (4) a more searching review is required under *Fox*, because the agency altered its position. We address each in turn.

1

Under *State Farm*, the touchstone of "arbitrary and capricious" review under the APA is "reasoned decisionmaking." *State Farm*, 463 U.S. at 52. "[T]he 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.'" *Id*. at 43 (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)). "[A]gency action is lawful only if it rests 'on a consideration of the relevant factors.'" *Michigan v. EPA*, 135 S. Ct. 2699, 2706 (2015) (quoting *State Farm*, 463 U.S. at 43). However, we may not set aside agency action simply because the rulemaking process could have been improved; rather, we must determine whether the agency's "path may reasonably be discerned." *State Farm*, 463 U.S. at 43 (quoting *Bowman Transp., Inc. v. Ark.-Best Freight Sys., Inc.*, 419 U.S. 281, 286 (1974)).

In considering and responding to comments, "the 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.'" *Id*. (quoting *Burlington Truck Lines*, 371 U.S. at 168). "[A]n agency need only respond to 'significant' comments, *i.e.*, those which raise relevant points and which, if adopted, would require a change in the agency's proposed rule." *Am. Mining Congress v. EPA*, 965 F.2d 759, 771 (9th Cir. 1992) (quoting *Home Box Office v. FCC*, 567 F.2d 9, 35 & n.58 (D.C. Cir. 1977) (per curiam)). If the comments ignored by the agency would not bear on the agency's "consideration of the relevant factors," we may not reverse the agency's decision. *Id.*

Treasury published its notice of proposed rulemaking in 2002. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. 48,997-01. In its notice, Treasury made clear that it was relying on the commensurate with income provision. *Id.* at 48,998. To support its position, Treasury drew from the legislative history of the 1986 amendment, explaining that Congress intended a party to a QCSA to "bear its portion of all research and development costs." *Id.* (quoting H.R. Rep. No. 99-841, at II-638 (Conf. Rep.)). It also informed interested parties of its intent to coordinate the new regulations with the arm's length standard, suggesting that it was attempting to synthesize the potentially disparate standards found within § 482 itself. *Id.* at 48,998, 49,000-01.

Commenters responded by attacking the proposed regulations as inconsistent with the traditional arm's length standard because the methodology did not involve analysis of comparable transactions. To support their position, they primarily discussed arm's length agreements in which unrelated parties did not mention employee stock options. They explained that unrelated parties do not share stock compensation costs because it is difficult to value stock-based compensation, and there can be a great deal of expense and risk involved.

In the preamble to the final rule, Treasury dismissed the comments (and, relatedly, the behavior of controlled taxpayers):

> Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties . . .). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." *See* H.R. Conf. Rep. No. 99-481, at II-638 (1986). . . . [I]n order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the intangibles pursuant to the QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.
>
> Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances. . . . 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.

Compensatory Stock Options under Section 482 (Preamble to Final Rule), 68 Fed. Reg. 51,171-02, 51,172-73 (Aug. 26, 2003).

Treasury added:

> Treasury and the IRS believe that if a significant element of [the costs shared by unrelated parties] consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

Id. at 51,173.

By submitting the cited transactions between unrelated parties, the commentators apparently assumed that Treasury would employ analysis of comparable transactions. This assumption, however, overlooks Treasury's decision to do away with analysis of comparable transactions in the first place – a decision that was made clear enough by citations to legislative history in the notice of proposed rulemaking and in the preamble to the final rule. As discussed in our *Chevron* analysis, Treasury's conclusion that it could require parties to a QCSA to share all costs was a reasonable one. Thus, "significant" comments that required a response would have spoken to why this interpretation was not, in fact, reasonable, so that adopting the comments would require Treasury to change the regulation. *Am. Mining Congress*, 965 F.2d at 771. As an example, Treasury would have been required to respond to comments demonstrating that doing away with analysis of comparables did not, in fact, serve the purposes of parity set out in the statute.

Indeed, the cited transactions actually reinforced the original justification for adopting a purely internal methodology – the lack of transactions comparable to those occurring between parties to a QCSA. Specifically, as Treasury remarked, the submitted transactions did not "share enough characteristics of QCSAs involving the development of high-profit intangibles" to provide grounds for accurate comparison. Because of this lack of similar transactions, Treasury justifiably chose to employ methodology that did not depend on non-existent comparables to satisfy the commensurate with income test and achieve tax parity. In this way, the comments reinforced Treasury's premise for adopting the purely internal methodology, but were irrelevant to the underlying choice of methodology. Treasury did not err in refusing to examine them more rigorously.

In sum, we cannot find a failure in Treasury's refusal to consider comments that proved irrelevant to its decisionmaking process. Here, Treasury gave sufficient notice of what it intended to do and why, and the submitted comments were irrelevant to the issues Treasury was considering. Because the comments had no bearing on "relevant factors" to the rulemaking, nor any bearing on the final rule, there was no APA violation. *Am. Mining Congress*, 965 F.2d at 771.

2

Treasury's current litigation position is not inconsistent with the statements it made to support the 2003 regulations at the time of the rulemaking. Altera argues that its position is justified by *SEC v. Chenery Corp.*, 332 U.S. 194 (1947). "[A] reviewing court . . . must judge the propriety of [agency] action solely by the grounds invoked by the agency." *Id.* at 196. "If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis." *Id.*

Altera argues that the Commissioner cannot now claim that "Treasury reasonably determined that it was statutorily authorized to dispense with comparability analysis" because "[n]owhere in the regulatory history did the Secretary suggest that he 'was statutorily authorized to dispense with comparability analysis.'" But these arguments misunderstand the rulemaking requirements imposed by *Chenery*. *Chenery* does not require us to adopt Altera's position as to how the arm's length standard operates. Instead, we must "defer to an interpretation which was a necessary presupposition of [the agency's] decision," if reasonable, even when alternative interpretations are available. *Nat'l R.R. Passenger Corp. v. Boston & Maine Corp.*, 503 U.S. 407, 419-20 (1992).

Treasury reasonably interpreted congressional intent in the 1986 amendments as permitting it to dispense with a comparable transaction analysis in the absence of actual comparable transactions. Its interpretation was all the more reasonable given, as we have discussed, that the arm's length standard has historically been understood as more fluid than Altera suggests. Because *Chener*y does not require agencies to provide "exhaustive, contemporaneous legal arguments to preemptively defend its action," its references to the 1986 amendments provide an adequate ground for its determination. *Nat'l Elec. Mfrs. Ass'n v. U.S. Dep't of Energy*, 654 F.3d 496, 515 (4th Cir. 2011).

Altera contends further that the Commissioner's position is incompatible with Treasury's statements during the rulemaking process, when the Secretary claimed that the cost-sharing regulations were consistent with the arm's length standard (as well as the commensurate with income standard). This argument misinterprets Treasury's position. Treasury asserted then, and still asserts in this litigation, that using an internal method of reallocation is consistent with the arm's length standard because it attempts to bring parity to the tax treatment of controlled and uncontrolled taxpayers, as does comparison of comparable transactions when they exist. Treasury's position was also consistent with its White Paper,[9] and Treasury's interpretation in the 1994 regulation of the arm's length standard as result-oriented, rather than method-oriented, with the goal of achieving tax parity. 26 C.F.R. § 1.482-1(b)(1) (1994).

Altera's argument is founded on its belief that an arm's length analysis always must be method-oriented, and rooted in actual transactional analysis. But the question before us is not which view is superior; it is whether Treasury's position in 2003 was incompatible with its prior position in promulgating the 1994 and 1995 regulations. As we have discussed, it was clear in 1994 and 1995 that, in implementing the commensurate with income amendment, Treasury was moving away from a purely method-based, comparable-transaction view of the arm's length standard in attempting to achieve tax parity. Treasury's citation to the amendment, and its legislative history,

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[9] Altera argues that a passage in the White Paper, in which Treasury wrote that "intangible income must be allocated on the basis of comparable transactions if comparables exist," demonstrates inconsistency. However, that statement is entirely consistent with Treasury's view that a different methodology must be applied when comparable transactions do *not* exist.

demonstrates that its position was not inconsistent, and there is no basis under *Chenery* to invalidate it.

3

Altera also argues that Treasury did not adequately support its position that employee stock compensation is a cost, asserting that Treasury wrongfully ignored evidence that companies do not factor stock-based compensation into their pricing decisions. As an accounting matter in the past, this issue may have been disputed. Indeed, at one point, "[t]he debate on accounting for stock-based compensation . . . became so divisive that it threatened the [Financial Accounting Standards] Board's future working relationship with some of its constituents." Financial Accounting Standards Board, Financial Accounting Foundation, Accounting for Stock-Based Compensation: Statement of Financial Accounting Standards No. 123, at 25 (1995). However, as we will discuss, it is uncontroversial today. Since 1995, the Financial Accounting Standards Board has supported treating stock options as costs. *Id.*

Treasury's rulemaking process was sufficient. Treasury articulated why treating stock-based compensation as a cost led to arm's length results. It first noted that stock-based compensation is a "critical element" of R&D costs for parties to a QCSA and noted that such compensation is "clearly related to the intangible development area." Compensatory Stock Options Under Section 482 (Preamble to Final Rule), 68 Fed. Reg. at 51,173. Logic supports these conclusions. Parties dealing at arm's length, as Treasury explained, would not "ignore" stock-based compensation if such compensation were a "significant element" of the compensation costs one party incurs and another party agrees to reimburse when developing high-profit intangibles. *Id*. Rather, "through bargaining," each party would ensure that the cost-sharing agreement is in its best interest, meaning that the parties will consider the internal costs of stock compensation without requiring the other party to recognize those costs. *Id*.

Though commentators presented evidence of some transactions in which stock-based compensation was not a cost, this evidence provided little guidance because it did not concern parties to a QCSA developing high-profit intangibles. This out-of-context data did not require a different decision. In the absence of applicable evidence, Treasury's analysis provides a logical explanation of how treating stock-based compensation as a cost leads to arm's length results.

In addition, as we have noted, generally accepted accounting principles supported Treasury's conclusion, and Treasury cited generally to "tax and other accounting principles" for its determination that there is a "cost associated with stock-based compensation." Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 48,999. One such principle is that a distinction exists between the economic costs of stock compensation – which are debatable – versus the accounting costs – which are not. Because entities account for the cost of providing employee stock options, it is reasonable for Treasury to allocate that cost. In light of these fundamental understandings, Treasury's reference to "tax and other accounting principles" provides a solid foundation for the Commissioner's interpretation.[10]

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[10] *See*, *e.g.*, Andrew Barry, *How Much Do Silicon Valley Firms Really Earn?*, Barron's (June 27, 2015), http://www.barrons.com/articles/how-much-do-silicon-valley-firms-really-earn-1435372718)) (noting that numerous companies, including

Most notably, the Tax Code classifies stock-based compensation as a trade or business "expense." 26 U.S.C. § 162(a). And the challenged regulation cites the provision providing that this expense is a deductible expense. 26 C.F.R. § 1.482-7A(d)(2)(iii)(A) ("[T]he operating expense attributable to stock-based compensation is equal to the amount allowable . . . as a deduction for Federal income tax purposes . . . (for example, under [26 U.S.C. § 83(h)])."). The reference to the Tax Code's classifications in the regulation itself serves as yet another articulation of Treasury's reasoning, the reasonableness of which is made clear by the Tax Code's treatment of stock-based compensation as a cost.

Though it could have been more specific, Treasury "articulated a rational connection" between its decision and these industry standards. *County of Amador v. U.S. Dep't of Interior*, 872 F.3d 1012, 1027 (9th Cir. 2017) (internal quotation marks omitted), *cert. denied*, 139 S. Ct. 64 (2018). Presuming that Treasury was authorized to dispense with a comparability analysis, making the economic behavior of uncontrolled taxpayers irrelevant, Altera does not offer any compelling argument against the reasonableness of Treasury's determination.

4

Finally, in addition to its general *State Farm* argument, Altera asks for a more searching review under *Fox*. Altera claims that the cost-sharing amendments present a major shift in administrative policy such that Treasury could not issue the regulations without carefully considering and broadcasting its decision.

Google and Qualcomm, reported stock compensation "total[ling] five percent or more of revenue in recent years").

Altera argues that "[t]he assertion that the commensurate with income clause supplants the arm's-length standard with a 'purely internal' analysis is a sharp – but unacknowledged – reversal from Treasury's longstanding prior policy."

"Agencies are free to change their existing policies as long as they provide a reasoned explanation for the change." *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016). Indeed, "[w]hen an agency changes its existing position, it 'need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate.'" *Id.* at 2125-26 (quoting *Fox*, 556 U.S. at 515). However, an agency may not "depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." *Fox*, 556 U.S. at 515.

> [A] policy change complies with the APA if the agency
>
> (1) displays "awareness that it is changing position,"
>
> (2) shows that "the new policy is permissible under the statute,"
>
> (3) "believes" the new policy is better, and
>
> (4) provides "good reasons" for the new policy, which, if the "new policy rests upon factual findings that contradict those which underlay its prior policy," must include "a reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy."

Organized Vill. of Kake v. U.S. Dep't of Agric., 795 F.3d 956, 966 (9th Cir. 2015) (en banc) (format altered) (quoting *Fox*, 556 U.S. at 515-16).

At its core, this argument is not meaningfully different from Altera's general APA argument. If the arm's length standard allows the Commissioner to allocate costs between related parties without a comparability analysis, there is no policy change, merely a clarification of the same policy. Further, as we have discussed, the policy change was occasioned by the congressional addition of the "commensurate with income" sentence in the Tax Reform Act of 1984 and the 1994 and 1995 implementing regulations. Those changes occurred well before 2003. The 2003 regulations clarified, rather than altered, prior policy. And the enactment of a statutory amendment obviously makes a concomitant regulatory amendment appropriate.

5

Thus, the 2003 regulations are not arbitrary and capricious under the standard of review imposed by the APA. Treasury's regulatory path may be reasonably discerned. Treasury understood § 482 to authorize it to employ a purely internal, commensurate with income approach in dealing with related companies. It provided adequate notice of its intent and adequately considered the objections. Its conclusion that stock based compensation should be treated as a cost was adequately supported in the record, and its position did not represent a policy change under *Fox*.

C

Altera also argues that the outcome of this case is controlled by our court's decision in *Xilinx*. We disagree. Although the *Xilinx* panel could have reached a holding that would foreclose the Commissioner's current position, it did not.

In *Xilinx*, we considered the 1994 and 1995 cost-sharing regulations. The case involved a matter of regulatory interpretation, not executive authority. Xilinx, Inc., another maker of programmable logic devices, challenged the Commissioner's allocation of employee stock options between Xilinx and its Irish subsidiary. 598 F.3d at 1192. As framed by the panel, the issue was whether § 1.482-1 (1994) – which sets forth the arm's length standard – could be reconciled with § 1.482-7(d)(1) (1995) – under which parties to a QCSA were required to share "all . . . costs" incurred in developing intangibles. *Id*. at 1195.

Xilinx does not govern here. First, the parties in *Xilinx* were not debating administrative authority, and we did not consider the "commensurate with income" standard, which Congress itself did not see as inconsistent with the arm's length standard. Second, and more significantly, the *Xilinx* panel was faced with a conflict between two rules. If the rules were conceptually distinguishable, they were also in direct conflict. The arm's length rule, § 1.482-1(b)(1) (1994), listed specific methods for calculating an arm's length result. The all-costs provision was not one of those methods, as the first *Xilinx* majority noted. 567 F.3d at 491. Treasury issued the coordinating amendment in 2003, *after* the tax years at issue in *Xilinx*, and the arm's length regulation now expressly references the cost-sharing provision that Altera challenges. The *Xilinx* panel did not address the "open question" of whether the 2003 regulations remedied the error identified in that decision. 598 F.3d at 1198 n.4 (Fisher, J., concurring). Today, there is no conflict in the regulations, and Altera does not challenge the regulations on the ground that a conflict exists.

Xilinx did not involve the question of statutory interpretation, the Commissioner's authority, or the regulation at issue in this appeal: 26 C.F.R.

§ 1.482-7A(d)(2). Accordingly, it does not assist Altera.

IV

The 1986 amendment focused specifically on intangibles, and it gave Treasury the ability to respond to rapid changes in the high tech industry. "The broad language of [§ 482] reflects an intentional effort to confer the flexibility necessary to forestall . . . obsolescence." *Massachusetts v. EPA*, 549 U.S. 497, 532 (2007). In the modern economy, employee stock options are integral to R&D arrangements. In fact, in Altera's 2015 annual report, its stock-based compensation cost equaled nearly five percent of total revenue. Altera Corp., Annual Report for the Fiscal Year Ended Dec. 31, 2014 (Form 10-K). Simply speaking, the rise in employee stock compensation is an economic development that Treasury cannot ignore without rejecting its obligations under § 482.

In sum, we disagree with the Tax Court that the 2003 regulations are arbitrary and capricious under the standard of review imposed by the APA. While the rulemaking process was less than ideal, the APA does not require perfection. We are able to reasonably discern Treasury's path – Treasury understood § 482 to authorize it to employ a purely internal, commensurate with income approach where comparable transactions are not comparable.

In light of the statute's plain text and the legislative history, Treasury also reasonably concluded that Congress intended to hone the definition of the arm's length standard so that it could work to achieve an arm's length *result*, instead of forcing application of a particular comparability *method*. Given the long history of the application of other methods, and the text and legislative history of the Tax Reform Act of 1984, Treasury's understanding of its power to use methodologies other than a pure transactional comparability analysis was reasonable, and we defer to its interpretation under *Chevron*. The Commissioner did not exceed the authority delegated to him by Congress in issuing the regulations.

REVERSED.

O'MALLEY, Circuit Judge, dissenting:

"[T]he foundational principle of administrative law [is] that a court may uphold agency action only on the grounds that the agency invoked when it took the action." *Michigan v. EPA*, 135 S. Ct. 2699, 2710 (2015) (citing *SEC v. Chenery Corp.* ("*Chenery I*"), 318 U.S. 80, 87 (1943)). Prior to promulgating Treas. Reg. § 1.482-7A(d)(2), whose validity we consider here, Treasury repeatedly recognized that 26 U.S.C. § 482 requires application of an arm's length standard when determining the true taxable income of a controlled taxpayer – i.e., it requires Treasury to assess what a taxpayer dealing with an uncontrolled taxpayer would do in the same circumstances. And, Treasury just as consistently asserted that a comparability analysis is the only way to determine the arm's length standard; indeed, Treasury made clear that a comparability analysis is the cornerstone of the arm's length standard. Despite these consistent practices and declarations, in its preamble to § 1.482-7A(d)(2), Treasury stated, for the first time and with no explanation, that it may, *instead*, employ the "commensurate with income" standard to reach the required arm's length result.

Today, the majority justifies Treasury's about-face in three steps: (1) it finds that, by citing to the legislative history surrounding the enactment of the Tax Reform Act of 1986 in the preamble to § 1.482-7A(d)(2), Treasury implicitly communicated its understanding that Congress "permitt[ed] it to dispense with a comparable transaction analysis," Op. 40-41; (2) it finds that, by including that same cryptic citation to legislative history in its proposed notice of rulemaking, Treasury made it "clear enough" to interested parties that Treasury was changing its longstanding practice of applying a comparability analysis, Op. 38-39; and (3) it justifies Treasury's resort to the commensurate with income standard by invoking the second sentence of § 482 to conclude that Treasury may jettison the arm's length standard altogether – a justification Treasury never provided and one which does not withstand careful scrutiny.

The majority, thus, "suppl[ies] a reasoned basis for the agency's action that the agency itself has not given," *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (citing *SEC v. Chenery Corp.* ("*Chenery II*"), 332 U.S. 194, 196 (1947)), encourages "executive agencies' penchant for changing their views about the law's meaning almost as often as they change administrations," *BNSF Ry. Co. v. Loos*, 586 U.S. ___, No. 17-1042, slip op. at 9 (2019) (Gorsuch, J., dissenting), and endorses a practice of requiring interested parties to engage in a scavenger hunt to understand an agency's rulemaking proposals. That practice is inconsistent with another fundamental Administrative Procedure Act ("APA") principle: that a notice of proposed rulemaking "should be sufficiently descriptive of the 'subjects and issues involved' so that interested parties may offer informed criticism and comments." *Am. Mining Cong.*

v. U.S. EPA, 965 F.2d 759, 770 (9th Cir. 1992) (quoting *Ethyl Corp. v. EPA*, 541 F.2d 1, 48 (D.C. Cir. 1976) (en banc)). In so doing, the majority stretches "highly deferential" review, *Providence Yakima Med. Ctr. v. Sebelius*, 611 F.3d 1181, 1190 (9th Cir. 2010) (quoting *J & G Sales Ltd. v. Truscott*, 473 F.3d 1043, 1051 (9th Cir. 2007)), beyond its breaking point.

I would instead find, as the Tax Court did, that Treasury's explanation of its rule (to the extent any was provided) failed to satisfy the *State Farm* standard, that Treasury did not provide adequate notice of its intent to change its longstanding practice of employing the arm's length standard and using a comparability analysis to get there, and that its new rule is invalid as arbitrary and capricious. I would also hold that this court's previous decision in *Xilinx, Inc. v. Commissioner of Internal Revenue* ("*Xilinx II*"), 598 F.3d 1191 (9th Cir. 2010), controls and mandates an order affirming the Tax Court's decision. I therefore would affirm the judgment of the Tax Court that expenses related to stock-based compensation are not among the costs to be shared in qualified cost sharing arrangements ("QCSAs") under Treas. Reg. § 1.482-7(d)(1) (as amended in 2013). *See Altera Corp. v. Comm'r*, 145 T.C. 91, 92 (2015). For these reasons, I respectfully dissent.

I. Background

A. The Arm's Length Standard

1. Before 1986

"The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." *Comm'r v. First Sec. Bank of Utah*, 405 U.S. 394, 400

(1972) (quoting Treas. Reg. § 1.482-1(b)(1) (1971)). The "touchstone" of this tax parity inquiry is the arm's length standard. *Xilinx II*, 598 F.3d at 1198 n.1 (Fisher, J., concurring). Indeed, the first sentence of § 482 states that, "[i]n any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may . . . allocate gross income . . . if he determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." This sentence has always been viewed as requiring an arm's length standard. *See First Sec. Bank of Utah*, 405 U.S. at 400; *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 305 (1994).

Since the 1930s, Treasury regulations consistently have explained that, "[i]n 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." Treas. Reg. § 1.482-1(b)(1) (2003) (emphasis added). That is, income and deductions are to be allocated among related companies in the same way that unrelated companies negotiating at arm's length would allocate income and deductions. As far back as 1968, Treasury's regulations also required that, "[i]n order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions *must be comparable* to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement." Allocation of Income and Deductions Among Taxpayers, 33 Fed. Reg. 5848, 5854 (April 16, 1968) (emphasis added). That same regulation provided that Treasury may not allocate income with respect to QCSAs involving the development of intangible property unless doing so would be consistent with the arm's length standard. *Id.* (providing that, in "a bona fide cost sharing arrangement with respect to the development of intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property."). Therefore, at the time Congress enacted the 1986 amendment, Treasury's own regulations explicitly required a determination of what an arm's length result would show *and* required a comparability analysis to reach that result where comparable transactions exist.

The majority attempts to water down the text of Treasury's own regulations at the time. It contends that, "[a]lthough the Secretary adopted the arm's length standard, courts did not hold related parties to the standard by exclusively requiring the examination of comparable transactions." Op. 9. To support its position, the majority cites this court's decision in *Frank v. Int'l Canadian Corp.*, 308 F.2d 520, 528-29 (9th Cir. 1962), which disagreed that "'arm's length bargaining' is the sole criterion for applying the statutory language of [§ 482] in determining what the 'true net income' is of each 'controlled taxpayer.'" But, in *Oil Base, Inc. v. Commissioner of Internal Revenue*, 362 F.2d 212, 214 n.5 (9th Cir. 1966), this court clarified that the holding in *Frank* was an outlier, limited only to the peculiar facts of that case. *Frank's* departure from the arm's length analysis, the court held, was justified, in part, because "there was no evidence that arm's-length bargaining upon the specific commodities sold had produced a higher return" and because "the complexity of the circumstances surrounding the services rendered by the subsidiary" made it "difficult for the court to hypothesize an arm's-length transaction." *Id*. Significantly, the parties in *Frank* had stipulated to applying a standard other than the arm's length standard. *Id*.

There really can be no doubt that, prior to the 1986 amendment, this Circuit believed that an arm's length standard based on comparable transactions was the sole basis for allocating costs and income under the statute in all but the narrow circumstances outlined in *Frank* – including the presence of the stipulation therein. The majority's attempt to breathe life back into *Frank* is, simply, unpersuasive.

2. The 1986 Amendment

The 1986 amendment passed against the backdrop of Treasury's own longstanding practices did not change the obligation to employ an arm's length standard. Indeed, Congress left the first sentence of § 482 – the sentence that undisputedly incorporates the arm's length standard – intact. It merely added a second sentence providing that, "[i]n 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." Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562 (1986) (codified as amended at 26 U.S.C. § 482). The plain text of the statute limits the application of the commensurate with income standard to only *transfers* or *licenses* of intangible property.

This is consistent with the underlying purpose of the 1986 amendment. Congress explained in the committee report that it was introducing the commensurate with income standard to address a "recurrent problem" with transfers of highly valuable intangible property: "the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables." H.R. Rep. No. 99-426, at 423-24 (1985). Congress noted that "[i]ndustry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases," and that "[t]here are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable." *Id.* at 424-25. To address this *specific* gap, Congress found it "appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation . . . be commensurate with the income attributable to the intangible." *Id.* at 425. Congress did not make any other findings regarding the use of the commensurate with income standard for any transactions other than transfers or licenses of intangible property. Thus, the statute – read in light of this legislative history – did not grant Treasury the flexibility to depart from a comparability analysis whenever it sees fit; rather, it permitted a departure in the limited context of "any transfer (or license) of intangible property" because it had found that comparable transactions in such cases are frequently unrealistic.

Treasury reiterated the limited circumstances in which the commensurate with income standard applies in its 1988 "White Paper." It stated there that, even in the context of transfers or licenses of intangible property, the "intangible income must be allocated on the basis of comparable transactions if comparables exist." *A Study of Intercompany Pricing under Section 482 of the Code* ("White Paper"), I.R.S. Notice 88-123, 1988-1 C.B. 458, 474; *see also id.* at 473 (noting that, where "there is a true comparable for" the licensing of a "high profit potential intangible," the royalty rate for the license "must be set on the basis of the comparable because that remains the best measure of how third parties would allocate intangible income"). Only "in situations in which comparables do not exist" for transfers of intangible property would the commensurate with income standard apply. *Id*. at 474. Indeed, the United States continued to insist in tax treaties, and in documents that Treasury issued to explain these treaties, that § 482 mandated the arm's length principle, in all but this narrow category of intangible transfers. *See Xilinx II,* 598 F.3d at 1196-97 (citing tax treaty explanations); *see also id*. at 1198 n.1 (Fisher, J., concurring) (noting that "the 1997 United States-Ireland Tax Treaty, . . . and others like it, reinforce the arm's length standard as Congress' intended touchstone for § 482").[1]

B. Treatment of Stock-Based Compensation

In the early 1990s, related companies began to compensate certain employees who performed research and development activities pursuant to QCSAs by granting stock options and other stock-based compensation. *See id*. at 1192-93. This manner of compensation allowed companies to avoid the income reallocation mechanisms available under § 482 by including only the employees' cash compensation in the cost pool under the agreement, but not their stock-based compensation.

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[1] As the majority observes, more recent tax treaty explanations have also cited the alternative commensurate with income standard. Op. 32-33 (citing Technical Explanation of the US-Poland Tax Treaty, at 31 (Feb. 13, 2013)). Even these explanations, however, emphasize the primacy of the arm's length standard, and they assure the reader that the commensurate with income standard "operates consistently with the arm's-length standard." Technical Explanation of the US-Poland Tax Treaty, at 30-31 (Feb. 13, 2013).

To address this loophole, Treasury promulgated new regulations governing the tax treatment of controlled transactions in 1994 and 1995. These regulations affirmed that "the standard to be applied in every case" was the arm's length standard and that "an arm's length result generally will be determined by reference to the results of comparable transactions" because "identical transactions can rarely be located." Treas. Reg. § 1.482-1(b)(1) (as amended in 1994). They also provided that intangible development costs included "all of the costs incurred by . . . [an uncontrolled] participant related to the intangible development area." Treas. Reg. § 1.482-7(d)(1) (as amended in 1995). The IRS interpreted this latter "all costs" provision to include stock-based compensation, so that related companies in cost-sharing agreements would have to share costs of providing such compensation. *Xilinx II*, 598 F.3d at 1193-94.

When Xilinx, Inc. ("Xilinx") challenged the IRS's interpretation, the Tax Court decided that the agency's interpretation was inconsistent with Treas. Reg. § 1.482-1 because the IRS had not adduced evidence sufficient to show that unrelated parties transacting at arm's length would, in fact, share expenses related to stock-based compensation. *Xilinx v. Commissioner* ("*Xilinx I*"), 125 T.C. 37, 53 (2005). The Commissioner did not appeal this underlying factual finding and, instead, argued on appeal to this court that Treas. Reg. § 1.482-7 superseded the arm's length requirement of Treas. Reg. § 1.482-1. All three members of the divided panel therefore assumed that sharing expenses related to stock-based compensation would be inconsistent with the arm's length standard. *Xilinx II*, 598 F.3d at 1194 ("The Commissioner does not dispute the tax court's factual finding that unrelated parties would not share [employee stock options] as a cost."); *id.* at 1199 (Reinhardt, J., dissenting) (assuming that the Tax Court "correctly resolved" the issue of whether sharing stock-based compensation costs would constitute an arm's length result). The panel also assumed that Treas. Reg. § 1.482-7 required stock-based compensation expenses to be shared. *Id.* at 1196 (majority opinion) (noting that the "all costs" provision "does not permit any exceptions, even for costs that unrelated parties would not share"); *id.* at 1199 (Reinhardt, J., dissenting) (assuming that the "all costs" provision includes "employee stock option costs"). But a majority of the panel ultimately held that the arm's length standard, which it described as the fundamental "purpose" of the regulations, trumped Treas. Reg. § 1.482-7, and that stock-based compensation expenses could not be shared in the absence of evidence that unrelated parties would share such costs. *Id.* at 1196 (majority opinion); *see also id.* at 1198 n.1 (Fisher, J., concurring) (finding "the arm's length standard" to be "Congress' intended touchstone for § 482"). On that ground, this court affirmed the Tax Court's judgment in favor of Xilinx. *Id.* at 1196 (majority opinion).

C. The Regulations at Issue

While *Xilinx II* was pending before this court, Treasury promulgated the regulations at issue here. Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,172 (Aug. 26, 2003) (codified at 26 C.F.R. pts. 1 and 602). The amended regulations sought to reconcile the apparent contradiction between the arm's length standard in Treas. Reg. § 1.482-1 and the requirement that stock-based compensation expenses be shared under Treas. Reg. § 1.482-7. The former provision now specifies that § 1.482-7 "provides the specific methods to be used to evaluate whether a [QCSA] produces results consistent with an arm's length result." Treas. Reg. § 1.482-1(b)(2)(i) (2003). And § 1.482-7, in turn, now provides that a QCSA produces an arm's length result "if, and only if," the participants share all of the costs of intangible development – explicitly including costs associated with stock-based compensation – in proportion to their shares of reasonably anticipated benefits attributable to such development. Treas. Reg. § 1.482-7(d)(2) (2003).

Altera Corp. ("Altera U.S."), a Delaware corporation, and its subsidiary Altera International, a Cayman Islands corporation, (collectively "Altera") entered into a technology research and development cost-sharing agreement under which the related participants "agreed to pool their respective resources to conduct research and development using the pre-cost-sharing intangible property" and "to share the risks and costs of research and development activities they performed on or after May 23, 1997." *Altera*, 145 T.C. at 93. This agreement was effective from May 23, 1997 through 2007. *Id.* During the 2004-2007 taxable years, Altera U.S. granted stock options and other stock-based compensation to certain employees who performed research and development activities pursuant to the agreement. *Id.* The employees' cash compensation was included in the cost pool under the agreement, but their stock-based compensation was not. *Id.*

Altera timely filed an income tax return for its 2004-2007 taxable years. *Id.* at 94. Treasury responded by mailing notices of deficiency for those years, allocating income from Altera International to Altera U.S. by increasing Altera International's cost-sharing payments. *Id.* Treasury claimed its cost-sharing adjustments were for the purpose of bringing Altera in compliance with § 1.482-7(d)(2), now

§ 1.482-7A(d)(2). *Id*. Altera challenged the validity of § 1.482-7A(d)(2) in Tax Court, arguing that the new rule is arbitrary and capricious. *Id*. at 92. The Tax Court unanimously held, as discussed in more detail below, that the explanation Treasury offered in the preamble accompanying the new regulations was insufficient to justify those regulations under *State Farm*. *Id*. at 120-33. The Commissioner appeals that decision.

II. Discussion

The Tax Court considered and rejected Treasury's plainly stated explanation for its regulation – that Treasury applied the commensurate with income test because it could find no transactions comparable to the QCSAs at issue and that Treasury's analysis was actually *consistent* with the arm's length standard. The Commissioner now argues on appeal, however – and the majority accepts its new claim – that what Treasury was *actually* saying is that § 482 no longer requires a comparability analysis when Treasury concludes that any comparable transactions are imperfect and that the methodology for arriving at an arm's length result is, and always has been, fluid. I disagree. Specifically, as explained below, I believe that: (1) Treasury's rule is procedurally invalid and the majority's attempt to recreate the record surrounding its adoption cannot cure that flaw; (2) Treasury's purported interpretation of § 482 is wrong; and (3) related companies may not be required to share the cost of stock-based compensation under current law because comparable uncontrolled taxpayers would not do so.

A. The New Rule is Procedurally Invalid

Under the Administrative Procedure Act, we must "hold unlawful and set aside agency action . . . found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). Our review of an agency regulation is "highly deferential, presuming the agency action to be valid and affirming the agency action if a reasonable basis exists for its decision." *Crickon v. Thomas*, 579 F.3d 978, 982 (9th Cir. 2009) (quoting *Nw. Ecosystem All. v. U.S. Fish & Wildlife Serv.*, 475 F.3d 1136, 1140 (9th Cir. 2007)). But "an agency's action must be upheld, if at all, on the basis articulated by the agency itself." *State Farm*, 463 U.S. at 50 (citing *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)). For that reason, "[w]e may not supply a reasoned basis for the agency's action that the agency itself has not given." *Id.* at 43 (quoting *Chenery II*, 332 U.S. at 196).

I start, therefore, with what Treasury said when it promulgated the regulation at issue. In Treasury's notice of proposed rulemaking, the agency explained the origins of the commensurate with income standard and discussed the White Paper. Compensatory Stock Options Under Section 482, 67 Fed. Reg. 48,997, 48,998 (proposed July 29, 2002) (to be codified at 26 C.F.R. pt. 1). Treasury noted, in particular, the White Paper's observation "that Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm's length standard." *Id.* (citing White Paper, 1988-1 C.B. at 458, 477).

Treasury then detailed how the proposed rules would function, including that the new rules required stock-based compensation costs to be included among the costs shared in a QCSA to produce "results consistent with an arm's length result." *Id.* at 49,000-01. It acknowledged that "[t]he Tax Reform Act of 1986 . . . amended section 482 to require that consideration for intangible property *transferred* in a controlled transaction be commensurate with the income attributable to the intangible" property. *Id.* at 48,998 (emphasis added). But it then conclusively stated, based on a vague reference to the "legislative history of the Act," that parties may continue to enter into bona fide *research and development* cost sharing arrangements so long as "the income allocated among the parties reasonably reflect actual economic activity undertaken by each" – i.e., so long as these agreements to develop intangible property survive the commensurate with income standard. *Id.* (emphasis added). Not once did Treasury justify its application of the commensurate with income standard by stating that QCSAs of this kind constitute "transfers" of intangible property under the Tax Reform Act. And, while it generally cited to the legislative history of the 1986 amendments to § 482 – a fact on which the majority places great weight – it did not explain what portions of the legislative history it found pertinent or how any of that history factored into its thinking.

Treasury expanded on its reasoning in the preamble to the final rule. It explained that the tax treatment of stock-based compensation in QCSAs would have to be consistent "with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines)." 68 Fed. Reg. at 51,172. Treasury observed, however, that the legislative history of the 1986 amendment to § 482 "expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that participants' shares of income 'reasonably reflect the actual economic activity undertaken by each.'" *Id.*

(quoting H.R. Rep. No. 99-481, at II-638 (1986) (Conf. Rep.)). Again, Treasury never explained why QCSAs in which controlled parties share costs to develop intangibles would constitute "transfers" of intangibles sufficient to trigger the commensurate with income standard in the first place. Instead, it simply declared that, "in order for a QCSA to reach an arm's length result consistent with legislative intent," the QCSA must include stock-based compensation among the costs shared. *Id.*

Throughout the preamble, Treasury repeatedly emphasized that it was continuing to apply the arm's length standard. Treasury explained, for example, that "[t]he regulations relating to QCSAs *have as their focus* reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles." *Id.* (emphasis added). Treasury determined that "[p]arties *dealing at arm's length* in [a cost-sharing] arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation." *Id.* (emphasis added). And Treasury concluded that "[t]he final regulations provide that stock-based compensation must be taken into account in the context of QCSAs *because* such a result is consistent with the arm's length standard." *Id.* (emphasis added).

Yet, Treasury failed to consider comparable transactions submitted by commentators demonstrating that unrelated companies would never share the cost of stock-based compensation. Treasury responded to these comments invoking the arm's length standard. *See id.* (rejecting "comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances"). Treasury acknowledged that these comparable arm's-length transactions are typically relevant, but it determined that there were no comparable transactions available for QCSAs for the development of high-profit intangibles:

> While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. 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.

Id. at 51,172-73 (internal citation omitted).

The Tax Court held that Treasury's explanation for its regulation was insufficient under *State Farm*. *Altera*, 145 T.C. at 120-33. It found that Treasury "failed to provide a reasoned basis" for its "belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs." *Id.* at 123. The court acknowledged that agencies need not gather empirical evidence for *some* policy-based propositions, but it held that "the belief that unrelated parties would share stock-based compensation costs in the context of a QCSA" was not such a proposition. *Id.* In reaching this conclusion, the court observed that commentators submitted significant evidence during the rulemaking process indicating that unrelated parties would not share stock-based compensation costs in QCSAs; that the Tax Court itself had made a factual determination on that issue in *Xilinx I* – concluding they would not; and, that Treasury was required at least to attempt to gather empirical evidence before declaring that no such evidence was available. *Id*. at 123-24.

The Tax Court then detailed why Treasury's explanation for the regulations was insufficient. The court noted that only some QCSAs involved high-profit intangibles or included stock-based compensation as a significant element of compensation, yet Treasury failed to distinguish between QCSAs with and without those characteristics. *Id*. at 125-27. And the court found that Treasury responded only in conclusory fashion to a number of comments identifying comparable transactions or explaining why unrelated parties would not share stock-based compensation costs in QCSAs. *Id*. at 127-30. On these grounds, the Tax Court struck down the regulation. *Id*. at 133-34.

On appeal, the Commissioner does not meaningfully dispute the Tax Court's determination that Treasury's analysis under the arm's length standard was inadequate and unsupported. In its opening brief, it contends, instead, "that, in the context of a QCSA, the arm's-length standard does *not* require an analysis of what unrelated entities do under comparable circumstances." Appellant's Br. 57 (internal quotation marks omitted). In the Commissioner's view, Treasury's detailed explanations regarding its comparability analysis were merely "extraneous observations" – "since Treasury reasonably determined that it was statutorily authorized to dispense with comparability analysis in this narrow context, there was no need for it to establish that the uncontrolled transactions cited by commentators were insufficiently comparable." Appellant's Br. 64.

In its supplemental brief, the Commissioner reiterates that – despite its own earlier machinations to the contrary – one should not conflate comparability analysis with the arm's length standard. Appellant's Suppl. Br. 29-31. It also argues for the first time that Treasury's passing reference to the legislative history of § 482 not only justified its departure from a comparability analysis, but also explained that QCSAs to *develop* intangibles constitute *transfers* of intangibles under the second sentence of § 482.

The majority accepts the latest of the Commissioner's ever-evolving post-hoc rationalizations and then, amazingly, goes even further to justify what Treasury did here. First, it accepts the Commissioner's new explanation that the taxpayer's agreement to "divide beneficial ownership of any Developed Technology" constitutes a transfer of intangibles. E.R. 145. Second, it holds that Treasury's reference to the legislative history communicated its understanding that, when Congress enacted the 1986 amendment, it "delegate[d] to Treasury the choice of a specific methodology to" "ensure that income follows economic activity." Op. 27. The majority finds that Treasury implicitly communicated its understanding that Congress called upon it to move away from a comparability analysis and "to develop methods that [d]o not rely on analysis of" what it deems "problematic comparable transactions" when it sees fit. Op. 28-29. The majority finds that Treasury was therefore entitled to ignore the comparable transactions submitted by commentators because they purportedly did not "bear[] on 'relevant factors' to the rulemaking." Op. 39-40 (quoting *Am. Mining Cong.*, 965 F.2d at 771).

As to Altera's rejoinder that Treasury never suggested that it had the authority to "dispense with" the comparability analysis entirely, Appellee's Br. 43, the majority dismisses this argument, stating that, "historically[,] the definition of the arm's length standard has been a more fluid one." Op. 29. Finally, the majority concludes that the second sentence of § 482 not only allowed Treasury to dispense with a comparability analysis *but also allowed it to ignore the arm's length test altogether*.

I do not share the majority's views. Treasury may well have thought – incorrectly, I believe – that QCSAs involving the development of high-profit intangibles constitute transfers of intellectual property under the second sentence of § 482. It may also have believed that, given the fundamental characteristics of stock-based compensation in QCSAs and what the majority here calls the "fluid" definition of the arm's length standard, it could dispense with a comparability analysis entirely, regardless of whether QCSAs constitute transfers. *Cf. Xilinx II*, 598 F.3d at 1197 (Fisher, J., concurring) (hypothesizing why unrelated companies may not share stock-based compensation costs). It may – despite never taking this position before rehearing in this appeal – have even believed that the arm's length standard was not required at all in these circumstances by virtue of the second sentence of § 482. But the APA required Treasury to *say* that it was taking these positions, which depart starkly from Treasury's previous regulations. *See FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) ("[T]he requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it *is* changing position.").

The APA's safeguards ensure that those regulated do not have to guess at the regulator's reasoning; just as importantly, they afford regulated parties a meaningful opportunity to respond to that reasoning. Treasury's notice of proposed rulemaking ran afoul of these safeguards by failing to put the relevant public on notice of its intention to depart from a traditional arm's length analysis.[2] *See CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1080 (D.C. Cir. 2009) (holding that a final rule "violates the APA's notice requirement where 'interested parties would have had to divine [the agency's] unspoken thoughts'" (alteration in original) (quoting *Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 407 F.3d 1250, 1259-60 (D.C. Cir. 2005))). Asking Treasury to show its work in the preamble to its final rule – that is, to set forth when and why the agency believed that a comparability analysis is not required or even why an arm's length analysis can be eschewed – does not, as the majority states, "require agencies to provide 'exhaustive, contemporaneous legal arguments to preemptively defend its action.'" Op. 41 (*quoting Nat'l Elec. Mfrs. Ass'n v. U.S. Dep't of Energy*, 654 F.3d 496, 515 (4th Cir. 2011)). It is the essence of the review that the APA demands.

When the Tax Court conducted that review, it considered the explanation that Treasury offered, and it

[2] The majority also glosses over the Tax Court's criticism that the final rule applied to all QCSAs but was based only on Treasury's beliefs about the subset of QCSAs involving "high-profit intangibles" where stock-based compensation is a "significant element" of compensation. *Altera*, 145 T.C. at 125-26 (quoting Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,173). Treasury's failure to explain this leap and the Commissioner's failure to defend it provide another reason that Treasury failed to comply with the APA.

found that Treasury "failed to provide a reasoned basis" for its "belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs." *Altera*, 145 T.C. at 123. The Tax Court set forth in detail why Treasury's explanation for the regulations was insufficient. *Id*. at 125-30. Treasury offers no response to these findings; it simply invites this court to recreate the record and interpret § 482 in a way it never asked the Tax Court to do in order to supply a post-hoc justification for its decisionmaking. 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.

B. *Chevron* Does Not Save Treasury's Flawed Interpretation of Section 482

Even if Treasury did not err procedurally, I would still find that the regulations are impermissible under *Chevron*. The Commissioner does not argue that its interpretation of § 482 is compelled by the unambiguous text of the statute at step one of *Chevron*. Rather, he contends that § 482 does not directly resolve the question of whether Treasury may allocate the cost of stock-based compensation between related parties. The majority similarly reasons that "[§] 482 does not speak directly to whether the Commissioner may require parties to a QCSA to share employee stock compensation costs in order to receive the tax benefits associated with entering into a QSCA." Op. 25. It thus concludes that "there is no question that the statute remains ambiguous regarding the method by which Treasury is to make allocations based on stock-based compensation." Op. 25.

While I agree with the majority and the Commissioner that the statute is silent as to the precise question of whether the Commissioner may require parties to a QCSA to share the cost of stock-based compensation, I believe that the statute unambiguously communicates the types of cases in which each methodology applies. Specifically, § 482 dictates that the status quo – i.e, the arm's length standard – controls in "any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests." It also allows Treasury to employ the commensurate with income standard, but only "[i]n the case of any transfer (or license) of intangible property." Accordingly, the precise gap left by Congress in this case is the question of whether QCSAs constitute a "transfer" of "intangible property" under the second sentence of the statute. If yes, then Treasury may employ the commensurate with income standard to determine if related parties to a QCSAs would share the cost of stock-based compensation. If no, then Treasury must make that determination by employing a comparability analysis to reach an arm's length result. Because the statute does not expressly state that QCSAs for the development intangibles constitute "transfers" of intangibles, I would proceed to step two of *Chevron*.

At step two, we consider whether Treasury's interpretation is "arbitrary or capricious in substance, or manifestly contrary to the statute." *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 53 (2011) (internal citations omitted). The agency's interpretation is not arbitrary and capricious if it is "rationally related to the goals of the Act." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 388 (1999). "If the [agency]'s interpretation is permissible in light of the statute's text, structure and purpose, we must defer under *Chevron*." *Miguel-Miguel v. Gonzales*, 500 F.3d 941, 949 (9th Cir. 2007). Accordingly, I begin with the text of the statute.

The statutory text provides in relevant part:

> In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations . . . *if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.* In the case of any *transfer (or license) of intangible property* (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Section 482 (emphases added). It is undisputed that the first sentence of the statute requires an arm's length analysis; even the majority agrees with that longstanding principle. As previously explained, moreover, at the time Congress amended § 482, the arm's length standard was understood to require a comparability analysis. But, because transfers of intangible property oftentimes lacked comparable transactions, Congress added a second sentence to the statute. This sentence allows the Secretary to apply the commensurate with income standard to reach an arm's length result in the case of any *transfer* of intangible property.

The Commissioner contends, based on Treasury's purported belief that QCSAs are transfers of intangible property, that Treasury correctly interpreted § 482 to require that controlled companies share the cost of stock-based compensation. But, as noted above, Treasury never made, much less supported, a finding that QCSAs constitute transfers of intangible property. We cannot and should not conclude that the Commissioner's post-hoc interpretation would be permissible when Treasury never articulated such an interpretation. Even if it had, Treasury's own characterization of QCSAs as arrangements "for the *development* of high-profit intangibles" contradicts any conclusion that QCSAs constitute *transfers* of already existing intangible property. 68 Fed. Reg. at 51,173 (emphasis added). No rights are transferred when parties enter into an agreement to *develop* intangibles; this is because the rights to later-developed intangible property would spring *ab initio* to the parties who shared the development costs without any need to transfer the property. And, there is no guarantee when the cost-sharing arrangements are entered into that any intangible will, in fact, be developed. In such circumstances, Treasury should not have employed the commensurate with income standard.

The majority attempts to justify Treasury's departure from the comparability analysis in these circumstances by stating it was reasonable for Treasury to "determin[e] that uncontrolled cost-sharing arrangements," such as those submitted by the commentators, "do not provide helpful guidance regarding allocations of employee stock compensation." Op. 28. According to the majority, the legislative history "makes clear" that Congress "intended the commensurate with income standard to displace a comparability analysis where comparable transactions cannot be found." Op. 13. This reasoning fails for several reasons.

As noted, the text of the statute provides that Treasury may employ the commensurate with income standard only in the case of a transfer or license of intangible property – not whenever Treasury finds that uncontrolled transactions fail to provide helpful guidance. Congress did not leave a gap in the statute allowing Treasury to choose when one methodology displaces the other. Rather, it made its own findings regarding the relative helpfulness of comparable uncontrolled transactions in the case of a transfer or license of intangible property. It then amended § 482 to allow for the use of the commensurate with income methodology in those specific cases, but not in others. Congress's findings in the legislative history do not invite Treasury to make its own determinations regarding the helpfulness of other uncontrolled transactions. Nor do they allow Treasury to expand the category of cases in which the commensurate with income standard would apply when the statutory text states otherwise. Here, Treasury's only justification for eschewing the comparability analysis was its insistence that the legislative history allows it to disregard comparable transactions that it deems imperfect. This rationale is inconsistent with the plain text of the statute and thus, is impermissible under *Chevron*.

Even if Treasury could dispense with a comparability analysis whenever it believed no comparables exist, that interpretation would still fail step two of *Chevron* because uncontrolled comparable transactions do exist here. Even the majority acknowledges Treasury's view that a different methodology may only be applied "*when comparable transactions do not exist.*" Op. 41 n.9 (emphasis added). Treasury itself explained, in effect, that a precondition for the applicability of the commensurate with income standard is the lack of real-world comparable transactions with which to make an arm's length comparison. Such transactions, as Treasury admitted, would "ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard." 68 Fed. Reg. at 51,173. According to the majority, however, imperfect comparables are tantamount to the absence of comparables.

But the arm's length standard of § 482 does not require perfectly identical transactions – only comparable ones. As Altera notes, the Commissioner cannot "avoid the statutory limits on his ability to reallocate income by asserting that a related-party transaction is fundamentally different from all similar transactions between unrelated parties by virtue of the very fact that the parties are related." Appellee's Suppl. Br. 33. Such an interpretation would allow Treasury to dispense with the comparability analysis altogether because related parties, by virtue of common ownership, are always positioned differently than unrelated parties. Legislative history can only do so much – if any – work, and it certainly cannot set out an exception that swallows a rule codified by statute.

Even if Treasury were correct that no comparable transactions exist, Treasury's reasoning would still fail. Treasury concluded that it could allocate costs because there were no transactions in which parties at arm's length would even consider taking stock options into account in the context of an arrangement similar to a QCSA. *See* 68 Fed. Reg. at 51,173. But the absence of evidence is not evidence of absence. Indeed, the absence of any comparable transactions could itself mean that uncontrolled taxpayers would not share the costs of stock-based compensation. Treasury believes, however, that uncontrolled taxpayers would not enter into such transactions, and, rather than find the absence of such transactions meaningful to a comparison, believes it is justified in using different methodologies to assess income. But the fact that evidence of the absence of comparable transactions might support more favorable tax treatment does not mean that no comparison can be made.

Finally, while Treasury's interpretation of § 482 is "entitled to no less deference . . . simply because it has changed over time, . . . the agency must nevertheless engage in reasoned analysis sufficient to command our deference." *Good Fortune Shipping SA v. Comm'r of Internal Rev. Serv.*, 897 F.3d 256, 263 (D.C. Cir. 2018) (internal quotations and citations omitted); *Judalang v. Holder*, 132 S. Ct. 476, 483 n.7 (2011) (clarifying that the court's analysis of whether an agency provided a reasoned explanation under *State Farm* and its analysis of whether an agency's interpretation is permissible under *Chevron* step two is "the same, because under *Chevron* step two, we ask whether an agency interpretation is 'arbitrary or capricious in substance'"). Such a reasoned explanation, at a minimum, requires Treasury to "display awareness that it is changing position." *Good Fortune Shipping*, 897 F.3d at 263 (quoting *Fox*, 556 U.S. at 515). "An agency may not, for example, depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." *Fox*, 556 U.S. at 515. And an agency may need to "provide a more detailed justification than what would suffice for a new policy created on a blank slate . . . when, for example, . . . its prior policy has engendered serious reliance interests that must be taken into account." *Id.* (citing *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 736, 742 (1996)). "'Unexplained inconsistency' between agency actions is 'a reason for holding an interpretation to be an arbitrary and capricious change.'" *Organized Vill. of Kake v. USDA*, 795 F.3d 956, 966 (9th Cir. 2015) (en banc) (quoting *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005)).

As this court held in *Xilinx II*, the previous regulations preserved the primacy of the arm's length standard and its requirement of comparability analysis. *See Xilinx II*, 598 F.3d at 1195-96 (explaining the then-operative version of Treas. Reg. § 1.482-1). In amending those regulations, however, Treasury never indicated – either in the notice of proposed rulemaking or in the preamble accompanying the final rule – any awareness that it was changing course. Treasury instead repeated its previous policy that it need not conduct a comparability analysis where no comparable transactions can be found. *See* 68 Fed. Reg. at 51,172-73. It then ignored existing comparable transactions to reach what it claimed was "an arm's length result." *Id*.

The majority contends that this does not constitute a change because, "historically[,] the definition of the arm's length standard has been a more fluid one." Op. 29. But, as explained above, the comparability analysis has always been a defining aspect of the arm's length standard. The mere fact that Treasury may have been inconsistent in the way it has applied the arm's length standard, as the majority contends, does not mean that the statute permits a fluid definition of the standard. *City of Arlington v. FCC*, 569 U.S. 290, 327 (2013) (Roberts, C.J., dissenting) ("We do not leave it to the agency to decide when it is in charge."). Because Treasury departed from the comparability analysis and failed to provide a reasoned explanation for why the commensurate with income standard is permissible under the statute, I would find that Treasury's regulations constitute an impermissible interpretation of the statute at *Chevron* step two.

C. Stock-Based Compensation Is Not A Shared Cost Under Section 482

Because I would find that Treasury's regulations are procedurally and substantively defective, I would interpret the statute in the first instance, without deference. *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016) ("*Chevron* deference is not warranted where the regulation is procedurally defective – that is, where the agency errs by failing to follow the correct procedures in issuing the regulation." (internal quotations and citations omitted)); *Util. Air Regulatory Grp. v. EPA*, 573 U.S. 302, 321 (2014) ("[A]n agency interpretation that is inconsistent with the design and structure of the statute as a whole does not merit deference." (internal citations and quotations omitted)).

Because I would find the 2003 regulations were invalid, I believe that this court's decision in *Xilinx II* controls, and that the Tax Court properly entered judgment in favor of Altera. *Altera*, 145 T.C. at 134. Even if *Xilinx II* did not control, I would hold that related parties in QCSAs need not share costs associated with stock-based compensation.

I agree with the majority that § 482 does not address this issue expressly. But I agree with *amicus curia*e Cisco Systems, Inc. ("Cisco"), that, under the best reading of § 482, QCSAs are not subject to the commensurate with income standard. As Cisco points out, the commensurate with income standard applies only to a "transfer (or license) of intangible property," § 482, which is distinct from a cost sharing agreement for the joint development of intangibles, *see* White Paper, 1988-1 C.B. at 474 (noting that "bona fide research and development cost sharing arrangements" provide a way to "avoid[] section 482 transfer pricing issues related to the licensing or other transfer of intangibles"). The plain meaning of "transfer" indicates shifting ownership of an existing right from one party to another. But under a cost-sharing arrangement, parties agree to develop intangibles together. Because the intangible does not exist at the time the cost sharing arrangement is entered into, there can be no transfer either.

The majority contends that Congress's choice to use the word "any" is significant. It reasons that, because "§ 482 applies '[i]n the case of *any* transfer . . . of intangible property,'" the statute "cannot reasonably be read to exclude the transfers of expected intangible property." Op. 26. But, while "any" can be a broadening modifier, it must be read in the context of its surrounding text. *Cf. United States v. Gonzales*, 520 U.S. 1, 5 (1997) (finding that use of "any" modifies the term it precedes.); *see Ali v. Fed. Bureau of Prisons*, 552 U.S. 214, 226 (2008) (narrowing the effect of "any" based on the context in which it appears because "a word is known by the company it keeps." (internal citations and quotations omitted)).

Here, "any" does not modify "intangible property." Rather, it precedes and thus, applies only to "transfer." This indicates that, while the statutory text may cover any kind of transfer, including expected transfers, it does not cover any kind of intangible property – say, for example, intangible property that does not yet exist. Indeed, § 482 expressly defines the term "intangible property" by referencing the definition provided in § 367(d)(4). *See* § 482 (". . . any transfer (or license) of intangible property (*within the meaning of section 367(d)(4)*)." (emphasis added)). We need not guess at whether Congress intended a broad reading of the term because § 367(d)(4) enumerates specific categories of intangible property covered under the statute, and none of those categories contemplates the mere possibility that intangible property may someday exist.

While "any" may modify "transfer," moreover, QCSAs do not provide for future transfers; rather, as noted above, rights to later-developed intangible property – if ever developed – would spring *ab initio* to the parties who shared the development costs and would thereby dispense with any need to transfer those rights at some time in the future. I would conclude, absent additional evidence to conclude otherwise, that QCSAs are not transfers subject to the commensurate with income standard under § 482.

Rather, I would find that QCSAs are governed under the first sentence of § 482 and that Treasury may only allocate the cost of stock-based compensation among related companies if unrelated companies dealing at arm's length would do so under comparable circumstances. The evidence of comparable transactions submitted by commentators demonstrates that unrelated companies do not and would not share such costs. Thus, I would hold that an arm's length result is one in which related parties in QCSAs do not share costs associated with stock-based compensation.

The Commissioner contends that the backdrop against which Congress enacted the 1986 amendment demonstrates that Congress intended § 482 to require related companies to share stock-based compensation. But, as the majority admits, "[n]either the Tax Reform Act nor the implementing regulations specifically addressed allocation of employee stock compensation." Op. 17. This is because the practice of providing stock-based compensation did not develop on a major scale until the 1990s – after Congress passed the 1986 amendment. Therefore, Congress could not have been legislating against the backdrop of this particular type of tax avoidance. While it may choose to address this practice now, it cannot be deemed to have done so then.

Not all forms of tax avoidance amount to illegal tax evasion. The very definition of a loophole is a gap in the law or a set of rules. While Treasury may promulgate regulations to close such gaps, it must do so in a manner consistent with its statutory authority under the Tax Reform Act and with the procedures outlined in the APA. When it fails to comply with those requirements, its actions cannot be justified by the mere existence of the loophole. In other words, an arm's length result is not simply any result that maximizes one's tax obligations. For these reasons, I dissent.

APPENDIX B

UNITED STATES TAX COURT

Altera Corporation and Subsidiaries,
Petitioner

v.

Commissioner of Internal Revenue,
Respondent

Docket Nos. 6253-12, 9963-12.

Filed July 27, 2015.

In *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010), we held that, under the 1995 cost-sharing regulations, controlled entities entering into qualified cost-sharing agreements (QCSAs) need not share stock-based compensation (SBC) costs because parties operating at arm's length would not do so. In 2003 Treasury issued sec. 1.482-7(d)(2), Income Tax Regs. (final rule). The final rule requires controlled parties entering into QCSAs to share SBC costs. P is an affiliated group of corporations that filed consolidated returns for the years in issue. A-US, the parent company, is a Delaware corporation, and A-I, a subsidiary of A-US, is a Cayman Islands corporation. A-US and A-I entered into a QCSA. During its 2004-07 taxable years A-US granted SBC to its employees. A-US did not share the SBC costs with A-I. R determined deficiencies based on I.R.C. sec. 482 allocations R made pursuant to the final rule. P and R have filed cross-motions for partial summary judgment. P contends that the final rule is arbitrary and capricious under 5 U.S.C. sec. 706(2)(A) and *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983). R contends that the final rule is valid under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), or alternatively, under *State Farm*. *Held*: The final rule is a legislative rule – i.e., it is not an interpretive rule under 5 U.S.C. sec. 553(b) – because it has the force of law. *See Am. Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993). The final rule has the force of law because in I.R.C. sec. 7805(a) "Congress has delegated legislative power to" Treasury, *id.*, and Treasury "intended to exercise that power" when it issued the final rule, *id.* *Held*, *further*, whether *State Farm* or *Chevron* supplies the standard of review is immaterial because *Chevron* step 2 incorporates the reasoned decisionmaking standard of *State Farm*, *see Judulang v. Holder*, 565 U.S. ___, ___, 132 S. Ct. 476, 483 n.7 (2011), and we are being asked to decide whether Treasury reasonably concluded that the final rule is consistent with the arm's-length standard. *Held*, *further*, Treasury failed to support its belief that unrelated parties would share SBC costs with any evidence in the administrative record, *see State Farm*, 463 U.S. at 43; failed to articulate why all QCSAs should be treated identically, *see id.*; and failed to respond to significant comments, *see Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977). Additionally, Treasury's "explanation for its decision * * * runs counter to the evidence before" it. *State Farm*, 463 U.S. at 43. *Held*, *further*, the harmless error rule of 5 U.S.C. sec. 706 is inapplicable because it is not clear that Treasury would have adopted the final rule if it had been determined to be inconsistent with the arm's-length standard. *Held*, *further*, the final rule fails to satisfy *State Farm*'s reasoned decisionmaking standard and is therefore invalid. *See* 5 U.S.C. sec. 706(2)(A); *State Farm*, 463 U.S. at 43.

Andrew P. Crousore, Donald M. Falk, Joseph B. Judkins, Thomas Lee Kittle-Kamp, William G. McGarrity, Kristyn A. Medina, Brian D. Netter, Phillip J. Taylor, and *Allen Duane Webber*, for petitioner.

Farhad Asghar, Kevin G. Croke, Anne O'Brien Hintermeister, Allan Lang, Aaron T. Vaughan, and *Mary E. Wynne*, for respondent.

OPINION

Marvel, *Judge*: These consolidated cases are before the Court on the parties' cross-motions for partial summary judgment under Rule 121.[1] The issue presented by the parties' cross-motions is whether section 1.482-7(d)(2), Income Tax Regs. (final rule) – which the Department of the Treasury (Treasury) issued in 2003 and which requires participants in qualified cost-sharing arrangements (QCSAs) to share stock-based compensation costs to achieve an arm's-length result – is arbitrary and capricious and therefore invalid.

Background

Petitioner is an affiliated group of corporations that filed consolidated Federal income tax returns for the years at issue. During all relevant years, Altera Corp. (Altera U.S.), the parent company, was a Delaware corporation, and Altera International, a subsidiary of Altera U.S., was a Cayman Islands corporation. When petitioner filed its petitions with this

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code (Code) in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure. All APA section references are to the Administrative Procedure Act (APA), 5 U.S.C. secs. 551-559, 701-706 (2012).

Court, the principal place of business of Altera U.S. was in California.

I. Petitioner's R&D Cost-Sharing Agreement

Petitioner develops, manufactures, markets, and sells programmable logic devices (PLDs) and related hardware, software, and pre-defined design building blocks for use in programming the PLDs (programming tools). Altera U.S. and Altera International entered into concurrent agreements that became effective May 23, 1997: a master technology license agreement (technology license agreement) and a technology research and development cost-sharing agreement (R&D cost-sharing agreement).

Under the technology license agreement, Altera U.S. licensed to Altera International the right to use and exploit, everywhere except the United States and Canada, all of Altera U.S.' intangible property relating to PLDs and programming tools that existed before the R&D cost-sharing agreement (pre-cost-sharing intangible property). In exchange for the rights granted under the technology license agreement, Altera International paid royalties to Altera U.S. in each year from 1997 through 2003. As of December 31, 2003, Altera International owned a fully paid-up license to use the pre-cost-sharing intangible property in its territory.

Under the R&D cost-sharing agreement, Altera U.S. and Altera International agreed to pool their respective resources to conduct research and development using the pre-cost-sharing intangible property. Under the R&D cost-sharing agreement, Altera U.S. and Altera International agreed to share the risks and costs of research and development activities they performed on or after May 23, 1997. The R&D cost-sharing agreement was in effect from May 23, 1997, through 2007.

During each of petitioner's taxable years ending December 31, 2004, December 30, 2005, December 29, 2006, and December 28, 2007 (2004-07 taxable years), Altera U.S. granted stock options and other stock-based compensation to certain of its employees. Certain of the employees of Altera U.S. who performed research and development activities subject to the R&D cost-sharing agreement received stock options or other stock-based compensation. The employees' cash compensation was included in the cost pool under the R&D cost-sharing agreement. Their stock-based compensation was not included.

Pursuant to the R&D cost-sharing agreement, Altera International made the following cost-sharing payments to Altera U.S. for its 2004-07 taxable years:

Year	*Cost-sharing payment*
2004	$129,469,233
2005	160,722,953
2006	164,836,577
2007	192,755,438

II. Petitioner's Tax Reporting and Respondent's Section 482 Allocations

Petitioner timely filed its Forms 1120, U.S. Corporation Income Tax Return, for its 2004-07 taxable years. Respondent timely mailed notices of deficiency to petitioner with respect to its 2004-07 taxable years. The notices of deficiency allocated, pursuant to section 482, income from Altera International to Altera U.S. by increasing Altera International's cost-sharing payments for 2004-07 by the following amounts:

Year	*Cost-sharing payment adjustment*
2004	$24,549,315
2005	23,015,453
2006	17,365,388
2007	15,463,565

Bringing petitioner into compliance with the final rule was the sole purpose of the cost-sharing adjustments in the notice of deficiency.

III. Section 482

A. Arm's-Length Standard

Section 482 authorizes the Commissioner to allocate income and expenses among related entities to prevent tax evasion and to ensure that taxpayers clearly reflect income relating to transactions between related entities. The first sentence of section 482 provides, in relevant part, as follows:

> In any case of two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests, the Secretary[2] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
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[2] The term "Secretary" means the Secretary of the Treasury or his delegate. Sec. 7701(a)(11)(B).

Section 1.482-1(a)(1), Income Tax Regs., explains the purpose of section 482 as follows:

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer[3] on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. * * *

Section 1.482-1(b)(1), Income Tax Regs., provides that

> [i]n 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. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. * * *

The arm's-length standard is also incorporated into numerous income tax treaties between the United States and foreign countries. *See*, *e.g.*, Convention for the Avoidance of Double Taxation and the

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[3] The term "controlled taxpayer" means "any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers." Sec. 1.482-1(i)(5), Income Tax Regs.

Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, U.S.-U.K. (2001 U.S.-U.K. Income Tax Convention), art. 9, July 24, 2001, Tax Treaties (CCH) para. 10,901.09, at 201,019; U.S. Model Income Tax Convention of Nov. 15, 2006 (2006 U.S. Model Income Tax Convention), art. 9, Tax Treaties (CCH) para. 209.09, at 10,559; Treasury Department Technical Explanation of the 2001 U.S.-U.K. Income Tax Convention, art. 9, Tax Treaties (CCH) para. 10,911, at 201,306 ("This Article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code section 482."); Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, art. 9, Tax Treaties (CCH) para. 215, at 10,640 (same).

B. Commensurate-With-Income Standard

In 1986 Congress amended section 482 by adding, in relevant part, the following sentence: "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." Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1231(e)(1), 100 Stat. at 2562.

The House report that accompanied the House version of the 1986 amendment to section 482 states, in relevant part, as follows:

> Many observers have questioned the effectiveness of the "arm's length" approach of the regulations under section 482. A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables.

*   *   *   *   *   *   *

The problems are particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may transfer such intangibles to foreign related corporations or to possession corporations at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.

Certain judicial interpretations of section 482 suggest that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. * * *

In many cases firms that develop high profit-potential intangibles tend to retain their rights or transfer them to related parties in which they retain an equity interest in order to maximize their profits. * * * Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases.

There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. * * *

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The basic requirement of the bill is that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation must be commensurate with the income attributable to the intangible. * * *

In making this change, the committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. * * *

* * * * * * *

In requiring that payments be commensurate with the income stream, the bill does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under present law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight.

[H.R. Rept. No. 99-426, at 423-426 (1985), 1986-3 C.B. (Vol. 2) 1, 423-426.]

The conference report that accompanied the 1986 amendment to section 482 states, in relevant part, as follows:

In view of the fact that the objective of these provisions – that the division of income between related parties reasonably reflect the relative economic activity undertaken by each – applies equally to inbound transfers, the conferees concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account.

* * * * * * *

The conferees are also aware that many important and difficult issues under section 482 are left unresolved by this legislation. The conferees believe that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect.

In revising section 482, the conferees do not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably

> reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development stages would be included. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.
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> [H.R. Conf. Rept. No. 99-841 (Vol. II), at II-637 through II-638 (1986), 1986-3 C.B. (Vol. 4) 1, 637-638.]

C. Treasury's Position That the Commensurate-With-Income Standard Was Intended To Work Consistently With the Arm's-Length Standard

As the conference report suggested, Treasury and the Internal Revenue Service (IRS) conducted a comprehensive study of the regulations under section 482, the results of which they published in Notice 88-123, 1988-2 C.B. 458 (1988 White Paper).

The 1988 White Paper concluded that the arm's-length standard is the international norm for making transfer pricing adjustments. *Id.*, 1988-2 C.B. at 475 ("The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases." (Fn. ref. omitted.)). The 1988 White Paper further concluded that Congress intended for the commensurate-with-income standard to work consistently with the arm's-length standard. *See id*. ("To allay fears that Congress intended the commensurate with income standard to be implemented in a manner inconsistent with international transfer pricing norms and U.S. treaty obligations, Treasury officials publicly stated that Congress intended no departure from the arm's length standard, and that the Treasury Department would so interpret the new law.").

The 1988 White Paper explained that the commensurate-with-income standard is consistent with the arm's-length standard because

> [l]ooking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do. The general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible. [*Id.*, 1988-2 C.B. at 472.]

Accordingly, in technical explanations to numerous income tax treaties that the United States has entered into since then, Treasury has repeatedly affirmed that Congress intended for the commensurate-with-income standard to work consistently with the arm's-length standard. *See*, *e.g.*, Treasury Department Technical Explanation of the 2001 U.S.-U.K. Income Tax Convention, art. 9, Tax Treaties (CCH) para. 10,911, at 201,307 ("It is understood that the 'commensurate with income' standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard."); Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, art. 9, Tax Treaties (CCH) para. 215, at 10,640-10,641 (same).

IV. 1995 Cost-Sharing Regulations

We have previously considered whether controlled tax-payers must include stock-based compensation in the pool of costs to be shared. Most recently, in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010), we addressed the treatment of stock-based compensation with respect to taxable years subject to cost-sharing regulations that Treasury finalized in 1995 (1995 cost-sharing regulations). Because our findings and conclusions, and the conclusions of the U.S. Court of Appeals for the Ninth Circuit, in *Xilinx* are relevant in these cases, we briefly review the 1995 cost-sharing regulations, our Opinion in *Xilinx*, and the opinions of the U.S. Court of Appeals for the Ninth Circuit in that case.

A. Regulatory Provisions

The 1995 cost-sharing regulations prohibited the District Director from making allocations under section 482 "except to the extent necessary to make each controlled participant's share of the costs * * * of intangible development under the qualified cost-sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development". T.D. 8632, 1996-1 C.B. 85, 90. The 1995 cost-sharing regulations further provided that "a controlled participant's costs of developing intangibles * * * [include] all of the costs incurred by that participant related to the intangible development area". *Id.*, 1996-1 C.B. at 92.

B. Our Opinion in *Xilinx*

In *Xilinx Inc. v. Commissioner*, 125 T.C. 37, the taxpayer challenged deficiencies determined under the 1995 cost-sharing regulations on the basis of the Commissioner's determination that the taxpayer should have included the value of stock-based compensation in the intangible development cost pool. Assuming arguendo that the value of stock-based compensation is a cost under the 1995 cost-sharing regulations, we held that the Commissioner's allocations failed to satisfy the arm's-length standard of section 1.482-1(b)(1), Income Tax Regs. *See id.* at 53.

In reaching this holding we concluded that, consistent with the 1995 cost-sharing regulations, (1) in determining the true taxable income of a controlled taxpayer, the arm's-length standard applies in all cases, *see id.* at 54-55; (2) the arm's-length standard requires an analysis of what unrelated entities would do, *see id.* at 53-54; (3) the commensurate-with-income standard was never intended to supplant the arm's-length standard, *see id.* at 56-58; and (4) unrelated parties would not share the exercise spread or grant date value[4] of stock-based compensation, *see id.* at 58-62.

In concluding that unrelated parties would not share either the exercise spread or grant date value of stock-based compensation, (1) we observed that the Commissioner's expert agreed that unrelated parties would not explicitly share the exercise spread or grant date value of stock-based compensation because unrelated parties would find it hard to agree how to measure such value and because doing so would leave them open to potential disputes, *see id.* at 58; (2) we found that the taxpayers proved that companies do not take into account either the exercise spread or grant date value of stock-based compensation for product pricing purposes, *see id.* at 59; (3) we observed that the Commissioner produced no credible evidence showing that unrelated parties implicitly share the exercise spread or grant date value of stock-based compensation, *see id.*; (4) we credited the testimony of the taxpayers' numerous fact witnesses who testified that unrelated parties do not share either the exercise spread or grant date value of stock-based compensation in cost-sharing agreements, *see id.*; (5) we found that the taxpayers proved that "if unrelated parties believed that the spread and grant date value were costs", they "would be very explicit about their treatment", *id.*; (6) we credited the testimony of the tax-payers' expert who testified that unrelated parties would not agree

[4] The exercise spread value is the spread between the option strike price and the price of the underlying stock when the option is exercised. *See Xilinx Inc. v. Commissioner*, 125 T.C. 37, 47 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). The grant date value is the fair market value of the option on its grant date. *See id.* at 50.

to share spread-based cost because doing so would create perverse incentives for each party to diminish the stock price of the other, *see id.* at 61; and (7) we observed that during the years in issue the grant value of stock-based compensation was generally not treated as an expense for tax and financial accounting purposes, *see id.* at 61-62.

C. The Ninth Circuit Opinions in *Xilinx*

The U.S. Court of Appeals for the Ninth Circuit initially reversed our Opinion in *Xilinx*. The majority opinion by Judge Fisher reasoned that "[b]ecause the all costs requirement [of the 1995 cost-sharing regulations] is irreconcilable with the arm's length standard," the more specific all costs requirement controls. *Xilinx Inc. v. Commissioner*, 567 F.3d 482, 489 (9th Cir. 2009), *rev'g and remanding* 125 T.C. 37, *withrawn*, 592 F.3d 1017 (9th Cir. 2010). The dissenting opinion by Judge Noonan agreed that the regulations were irreconcilable, *see id.* at 497 (Noonan, J., dissenting), but concluded that the all costs requirement should be construed as not applying to stock-based compensation because (1) the regulations should be interpreted in the light of the dominant purpose of the statute – "parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions", *id.* at 498; (2) any inconsistencies in the regulations should be construed against the Government, *see id.*; and (3) Treasury's technical explanation of the income tax convention between the United States and Ireland confirms that the commensurate-with-income standard is meant to work consistently with the arm's-length standard, *see id.* at 498-500 ("This article incorporates in the Convention the arm's[-]length principle reflected in the U.S. domestic transfer pricing provision, particularly Code section 482. * * * It is understood that the 'commensurate with income' standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard." (quoting Treasury Department Technical Explanation of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains Signed at Dublin on July 28, 1997, and the Protocol Signed at Dublin on July 28, 1997 (1997 U.S.-Ir. Income Tax Convention and Protocol), U.S.-Ir., Tax Treaties (CCH) para. 4435, at 103,223)).

The Court of Appeals subsequently withdrew its opinion in *Xilinx* and issued a new opinion affirming our Opinion in *Xilinx*. The new opinion by Judge Noonan was in substance similar to his original dissenting opinion, with the exception that the new opinion did not rest its reasoning on the notion that inconsistencies in the regulations should be resolved against the Government. *See Xilinx Inc. v. Commissioner*, 598 F.3d at 1191-1197 (Noonan, J.).

Judge Fisher's concurring opinion first explained the parties' "dueling interpretations of the 'arm's length standard'". *Id.* at 1197 (Fisher, J., concurring). According to Judge Fisher, Xilinx contended that the arm's-length standard required "controlled parties * * * [to] share only those costs uncontrolled parties share." *Id.* By contrast, the Commissioner contended that

> analyzing comparable transactions is unhelpful in situations where related and unrelated parties always occupy materially different circumstances. As applied to sharing * * * [employee-stock-option (ESO)] costs, the Commissioner argues (consistent with the tax court's findings) that the reason unrelated parties do not, and would not, share ESO

> costs is that they are unwilling to expose themselves to an obligation that will vary with an unrelated company's stock price. Related companies are less prone to this concern precisely because they are related – i.e., because XI is wholly owned by Xilinx, it is already exposed to variations in Xilinx's overall stock price, at least in some respects. * * * [*Id.*]

Judge Fisher concluded "that Xilinx's understanding of the regulations is the more reasonable even if the Commissioner's current interpretation may be theoretically plausible." *Id.* at 1198. He further explained that "we need not defer to * * * [the Commissioner's interpretation of the arm's-length standard] because he has not clearly articulated his rationale until now." *Id.* (citing *United States v. Thompson/Ctr. Arms Co.*, 504 U.S. 505, 518-519 & n.9 (1992)). In a footnote Judge Fisher added: "It is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case." *Id.* n.4. Notwithstanding Judge Fisher's concerns, Judge Reinhardt, dissenting, would have continued to adhere to the panel's original opinion. *See id.* at 1199-1200 (Reinhardt, J., dissenting).

V. 2003 Cost-Sharing Regulations

A. Notice of Proposed Rulemaking

In July 2002 Treasury issued a notice of proposed rule-making and notice of a public hearing (NPRM) with respect to proposed amendments to the 1995 cost-sharing regulations. The NPRM set a public hearing on the proposed amendments for November 20, 2002. *See* 67 Fed. Reg. 48997 (July 29, 2002). The preamble to the NPRM states that the proposed amendments to the 1995 cost-sharing regulations sought to clarify

> that stock-based compensation must be taken into account in determining operating expenses under § 1.482-7(d)(1)[, Income Tax Regs.,] and to provide rules for measuring stock-based compensation costs * * * [, and] to include express provisions to coordinate the cost sharing rules of § 1.482-7[, Income Tax Regs.,] with the arm's length standard as set forth in § 1.482-1[, Income Tax Regs.]. [*Id.* at 48998.]

B. Comments Submitted in Response to the Proposed Regulations

In response to the NPRM the following persons and organizations submitted written comments to Treasury: (1) American Electronics Association (AeA); (2) Baker & McKenzie, LLP, on behalf of the Software Finance and Tax Executives Council (SoFTEC); (3) Deloitte & Touche, LLP; (4) Ernst & Young LLP, on behalf of the Global Competitiveness Coalition (Global); (5) Fenwick & West, LLP (Fenwick); (6) Financial Executives International (FEI); (7) Information Technology Association of America; (8) Information Technology Industry Council; (9) KPMG, LLP; (10) PricewaterhouseCoopers, LLP (PwC); (11) Irish Office of the Revenue Commissioners; (12) Joseph A. Grundfest, W.A. Franke Professor of Law and Business, Stanford Law School; (13) Xilinx Inc. Additionally, the following four persons spoke at the November 20, 2002, public hearing: (1) Eric D. Ryan, of PwC; (2) Ron Schrotenboer, of Fenwick; (3) John M. Peterson, Jr., of Baker & McKenzie, LLP and on behalf of SoFTEC; and (4) Caroline Graves Hurley, of AeA.[5]

Several of the commentators informed Treasury that they knew of no transactions between unrelated parties, including any cost-sharing arrangement, service agreement, or other contract, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation.

AeA provided to Treasury the results of a survey of its members. AeA member companies reviewed their arm's-length codevelopment and joint venture agreements and found none in which the parties shared stock-based compensation. For those agreements that did not explicitly address the treatment of stock-based compensation, the companies reviewed their accounting records and found none in which any costs associated with stock-based compensation were shared.

AeA and PwC represented to Treasury that they conducted multiple searches of the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system[6] and found no cost-sharing agreements between unrelated parties in which the parties agreed to share either the exercise spread or grant date value of stock-based compensation.

Several commentators identified arm's-length agreements in which stock-based compensation was

[5] Tax Analysts prepared a written transcript of the November 20, 2002, hearing. Treasury did not request or pay for the transcript and did not identify it as an "official" transcript.

[6] EDGAR is maintained by the Securities and Exchange Commission (SEC) and is a public and searchable database that provides users with free access to registration statements, periodic reports, and other forms filed by companies, including "material contracts" that are required by law to be attached as exhibits to certain SEC forms.

not shared or reimbursed. For example, (1) AeA identified, and PwC provided, a 1997 collaboration agreement between Amylin Pharmaceuticals, Inc., and Hoechst Marion Roussel, Inc. (Amylin-HMR collaboration agreement), that did not include stock options in the pool of costs to be shared; (2) PwC identified a joint development agreement between the bio-technology company AgraQuest, Inc., and Rohm & Haas under which only "out-of-pocket costs" would be shared; (3) PwC identified a 1999 cost-sharing agreement between software companies Healtheon Corp. and Beech Street Corp. that expressly excluded stock options from the pool of expenses to be shared. Additionally, in written comments, and again at the November 20, 2002, hearing, Ms. Hurley offered to provide Treasury with more detailed information regarding several agreements involving AeA member companies, provided that the companies received adequate assurances that their proprietary information would not be disclosed.[7]

FEI submitted model accounting procedures from the Council of Petroleum Accountant Societies (COPAS) for sharing costs among joint operating agreement partners in the petroleum industry. FEI noted that COPAS recommends that joint operating agreements should not allow stock options to be charged against the joint account because they are difficult to accurately value.

AeA, SoFTEC, KPMG, and PwC cited the practice of the Federal Government, which regularly enters into cost-reimbursement contracts at arm's length.

[7] Respondent admits that Treasury never had any discussions with the AeA member companies regarding the arm's-length cost-sharing agreements that the AeA member companies offered to discuss.

They noted that Federal acquisition regulations prohibit reimbursement of amounts attributable to stock-based compensation.[8]

AeA, Global, and PwC explained that, from an economic perspective, unrelated parties would not agree to share or reimburse amounts related to stock-based compensation because the value of stock-based compensation is speculative, potentially large, and completely outside the control of the parties. SoFTEC provided a detailed economic analysis from economists William Baumol and Burton Malkiel reaching the same conclusion.

Finally, the Baumol and Malkiel analysis concluded that there is no net economic cost to a corporation or its shareholders from the issuance of stock-based compensation. Similarly, Mr. Grundfest asserted that a company's "decision to grant options to employees * * * does not change its operating expenses" and does not factor into its pricing decisions.

C. Final Rule

1. Regulatory Provisions

In August 2003 Treasury issued the final rule. The final rule explicitly required parties to QCSAs to share stock-based compensation costs. *See* sec. 1.482-7(d)(2), Income Tax Regs. The final rule also added sections 1.482-1(b)(2)(i) through 1.482-7(a)(3), Income Tax Regs., to provide that a QCSA produces an arm's-length result only if the parties' costs are determined in accordance with the final rule. *See* T.D. 9088, 2003-2 C.B. 841, 847-848.

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[8] Federal acquisition regulations prohibit contractors from charging the Government for stock-based compensation. *See* 48 C.F.R. sec. 31.205-6(i) (2013).

The final rule provides two methods for measuring the value of stock-based compensation: a default method and an elective method. Under the default method, "the costs attributable to stock-based compensation generally are included as intangible development costs upon the exercise of the option and measured by the spread between the option strike price and the price of the underlying stock." *Id.*, 2003-2 C.B. at 844. Under the elective method, "the costs attributable to stock options are taken into account in certain cases in accordance with the 'fair value' of the option, as reported for financial accounting purposes either as a charge against income or in footnoted disclosures." *Id.* The elective method, however, is available only with respect to options on stock that is publicly traded "on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year." Sec. 1.482-7(d)(3)(iii)(B)(2), Income Tax Regs.

2. Lack of Evidence From Uncontrolled Transactions

When it issued the final rule, the files maintained by Treasury relating to the final rule did not contain any expert opinions, empirical data, or published or unpublished articles, papers, surveys, or reports supporting a determination that the amounts attributable to stock-based compensation must be included in the cost pool of QCSAs to achieve an arm's-length result. Those files also did not contain any record that Treasury searched any database that could have contained agreements between unrelated parties relating to joint undertakings or the provision of services. Additionally, Treasury was unaware of any written contract between unrelated parties, whether in a cost-sharing arrangement or otherwise, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation; or any evidence of any actual transaction between unrelated parties, whether in a cost-sharing arrangement or otherwise, in which one party paid or reimbursed the other party for amounts attributable to stock-based compensation.

3. Response to Comments

The preamble to the final rule responded to comments that asserted that the proposed amendments to the 1995 cost-sharing regulations were inconsistent with the arm's-length standard, in relevant part, as follows:

> Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." *See* H.R. Conf. Rep[t]. No. 99-481 [Vol. II], at II-638 (1986). * * * In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant

costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the intangibles pursuant to the QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.

Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Section 1.482-1(b)(1)[, Income Tax Regs.,] provides that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances." * * * While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. H.R. Rep[t]. No. 99-426, at 423-[4]25 (1985). 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. Government contractors that are entitled to reimbursement for services on a cost-plus basis under government procurement law assume substantially less entrepreneurial risk than that assumed by service providers that participate in QCSAs, and therefore the economic relationship between the parties to such an arrangement is very different from the economic relationship between participants in a QCSA. The other agreements highlighted by commentators establish arrangements that differ significantly from QCSAs in that they provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement. Such terms, which may have the effect of mitigating the impact of using a cost base to be shared or reimbursed that is less than comprehensive, would not be permitted by the QCSA regulations. * * *

The regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles. 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 in order to obtain the benefit of an independent right to exploit such 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.

For example, assume that two parties are negotiating an arrangement similar to a QCSA in order to attempt to develop patentable pharmaceutical products, and that they anticipate that they will benefit equally from their exploitation of such patents in their respective geographic markets. Assume further that one party is considering the commitment of several employees to perform research with respect to the arrangement. That party would not agree to commit employees to an arrangement that is based on the sharing of costs in order to obtain the benefit of independent exploitation rights unless the other party agrees to reimburse its share of the compensation costs of the employees. Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

[T.D. 9088, 2003-2 C.B. at 842-843.]

The preamble to the final rule responded to comments that asserted that stock-based compensation does not constitute an economic cost, or relevant economic cost, as follows:

Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account in the context of QCSAs is appropriate. The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard. Treasury and the IRS agree that the disposition of financial

> reporting issues does not mandate a particular result under these regulations. [*Id.*, 2003-2 C.B. at 843.]

The preamble to the final rule responded to comments that asserted that parties at arm's length would not share either the exercise spread or grant date value of stock-based compensation because they would produce results that are too speculative or not sufficiently related to the employee services that are compensated, as follows:

> Treasury and the IRS believe that it is appropriate for regulations to prescribe guidance in this context that is consistent with the arm's length standard and that also is objective and administrable. As long as the measurement method is determined at or before grant date, either of the prescribed measurement methods can be expected to result in an appropriate allocation of costs among QCSA participants and therefore would be consistent with the arm's length standard. [*Id.*, 2003-2 C.B. at 844.]

Finally, the preamble to the final rule states that "[i]t has also been determined that [APA] section 553(b) * * * does not apply to these regulations." *Id.*, 2003-2 C.B. at 847.

Discussion

I. Summary Judgment

Rule 121(a) provides that either party may move for summary judgment upon all or any part of the legal issues in controversy. Full or partial summary judgment may be granted only if it is demonstrated that there is no genuine dispute as to any material fact and that a decision may be rendered as a matter of law. *See* Rule 121(b); *Sundstrand Corp. v. Commissioner*, 98 T.C. 518, 520 (1992), *aff'd*, 17 F.3d 965 (7th Cir. 1994). We conclude that there is no genuine dispute as to any material fact relating to the issue presented by the parties' cross-motions for partial summary judgment and that the issue may be decided as a matter of law.

II. Applicable Principles of Administrative Law

A. Notice and Comment Rulemaking

Pursuant to APA sec. 553, in promulgating regulations through informal rulemaking an agency must (1) publish a notice of proposed rulemaking in the Federal Register,[9] *see* APA sec. 553(b); (2) provide "interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation", *id.* subsec. (c); and (3) "[a]fter consideration of the relevant matter presented, * * * incorporate in the rules adopted a concise general statement of their basis and purpose", *id.* These requirements do not apply to interpretive rules,[10] *see id.* subsec.

[9] The notice of proposed rulemaking must include "(1) a statement of the time, place, and nature of public rule making proceedings; (2) reference to the legal authority under which the rule is proposed; and (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved." APA sec. 553(b).

[10] We have previously referred to regulations issued pursuant to specific grants of rulemaking authority as legislative regulations and regulations issued pursuant to Treasury's general rulemaking authority, under sec. 7805(a), as interpretive regulations. *See, e.g.*, *Tutor-Saliba Corp. v. Commissioner*, 115 T.C. 1, 7 (2000). Because the terms "legislative" and "interpretive" have different meanings in the administrative law context, *see Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003), we will

(b)(A), or when an agency for good cause finds – and incorporates its findings in the rules issued – that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest", *id.* para. (B).

Generally, interpretive rules merely explain preexisting substantive law. *See Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003). Substantive (or legislative) rules by contrast, "create rights, impose obligations, or effect a change in existing law". *Id.* Stated simply, "legislative rules, unlike interpretive rules, have the 'force of law.'" *Id.* (quoting *Am. Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)); *see also Chrysler Corp. v. Brown*, 441 U.S. 281, 301-302 (1979).

A rule has the force of law "only if Congress has delegated legislative power to the agency and if the agency intended to exercise that power in promulgating the rule." *Am. Mining Cong.*, 995 F.2d at 1109 (citing *Am. Postal Workers Union v. USPS*, 707 F.2d 548, 558 (D.C. Cir. 1983)). The U.S. Court of Appeals for the Ninth Circuit, to which an appeal in these cases appears to lie absent a stipulation to the contrary, *see* sec. 7482(b)(1)(B), (2), has held that we can infer that an agency intends for a rule to have the force of law in any of the following circumstances: "(1) when, in the absence of the rule, there would not be an adequate legislative basis for enforcement action; (2) when the agency has explicitly invoked its general legislative authority; or (3) when the rule effectively amends a prior legislative rule," *Hemp Indus.*, 333

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refer to regulations issued pursuant to specific grants of rulemaking authority as specific authority regulations and regulations issued pursuant to Treasury's general rulemaking authority, under sec. 7805(a), as general authority regulations.

F.3d at 1087 (citing *Am. Mining Cong.*, 995 F.2d 1106), or "effect[s] a change in existing law or policy", *D.H. Blattner & Sons, Inc. v. Sec'y of Labor, Mine Safety & Health Admin.*, 152 F.3d 1102, 1109 (9th Cir. 1998) (alteration in original) (quoting *Powderly v. Schweiker*, 704 F.2d 1092, 1098 (9th Cir. 1983)). In determining whether a rule is interpretive or legislative we "need not accept the agency characterization at face value." *Hemp Indus.*, 333 F.3d at 1087 (citing *Gunderson v. Hood*, 268 F.3d 1149, 1154 n.27 (9th Cir. 2001)).

The notice and comment requirements of APA sec. 553 "are intended to assist judicial review as well as to provide fair treatment for persons affected by a rule." *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977). Accordingly, "there must be an exchange of views, information, and criticism between interested persons and the agency." *Id.* Additionally, because "the opportunity to comment is meaningless unless the agency responds to significant points raised by the public", an agency is required to respond to significant comments.[11] *Id.* at 35-36. However, "[t]he failure to respond to comments is significant only insofar as it demonstrates that the agency's decision was not based on a consideration of the relevant factors." *Sherley v. Sebelius*, 689 F.3d 776, 784 (D.C.

[11] "[O]nly comments which, if true, raise points relevant to the agency's decision and which, if adopted, would require a change in an agency's proposed rule cast doubt on the reasonableness of a position taken by the agency. Moreover, comments which themselves are purely speculative and do not disclose the factual or policy basis on which they rest require no response." *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35 n.58 (D.C. Cir. 1977); *see also Am. Mining Cong. v. EPA*, 965 F.2d 759, 771 (9th Cir. 1992) (citing *Home Box Office*, 567 F.2d at 35 & n.58).

Cir. 2012) (quoting *Covad Commc'ns v. FCC*, 450 F.3d 528, 550 (D.C. Cir. 2006)).

B. Judicial Review of Agency Decisionmaking – *State Farm* Review

Pursuant to APA sec. 706(2)(A), a court must "hold unlawful and set aside agency action, findings, and conclusions" that the court finds to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law". A court's review under this "standard is narrow and a court is not to substitute its judgment for that of the agency." *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983); *see also Judulang v. Holder*, 565 U.S. ___, ___, 132 S. Ct. 476, 483 (2011); *Citizens to Pres. Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971), *abrogated on other grounds by Califano v. Sanders*, 430 U.S. 99 (1977). However, a reviewing court must ensure that the agency "engaged in reasoned decisionmaking." *Judulang*, 565 U.S. at ___, 132 S. Ct. at 484. To engage in reasoned decisionmaking, "the 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.'" *State Farm*, 463 U.S. at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

In reviewing an agency action a court must determine "whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Id.* (quoting *Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 285 (1974)); *see also Judulang*, 565 U.S. at ___, 132 S. Ct. at 484. "Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *State Farm*, 463 U.S. at 43.

In providing a reasoned explanation for agency action that departs from an agency's prior position the agency must "display awareness that it is changing position." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) (citing *United States v. Nixon*, 418 U.S. 683, 696 (1974)). However, the agency need not demonstrate "that the reasons for the new policy are better than the reasons for the old one". *Id.*

In examining an agency's explanation for issuing a rule a reviewing court "'may not supply a reasoned basis for the agency's action that the agency itself has not given.'" *State Farm*, 463 U.S. at 43 (quoting *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)); *see also Carpenter Family Invs., LLC v. Commissioner*, 136 T.C. 373, 380, 396 n.30 (2011). Similarly, when an agency "relie[s] on multiple rationales (and has not done so in the alternative), and * * * [a reviewing court] conclude[s] that at least one of the rationales is deficient," *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839 (D.C. Cir. 2006) (citing *Allied-Signal, Inc. v. U.S. Nuclear Regulatory Comm'n*, 988 F.2d 146, 150-151 (D.C. Cir. 1993), and *Consol. Edison Co. of N.Y. v. FERC*, 823 F.2d 630, 641-642 (D.C. Cir. 1987)), the court cannot sustain the agency action on the basis of the sufficient rationale unless the court is certain that the agency would have taken the same action "even absent the flawed rationale", *id.* However, the reviewing court must "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *State Farm*, 463 U.S. at 43 (quoting *Bowman Transp.*, 419 U.S. at 286).

C. Judicial Review of Agency Statutory Construction – *Chevron* Review

A court reviews an agency's authoritative construction of a statute under the two-step test first articulated in *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). *See Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55-58 (2011). In *Mayo Found.*, the Supreme Court clarified that both specific authority regulations and general authority regulations are to be accorded *Chevron* deference.[12] *See id.*

Under *Chevron* step 1, "applying the ordinary tools of statutory construction," *City of Arlington v. FCC*, 569 U.S. ___, ___, 133 S. Ct. 1863, 1868 (2013), a court must determine "whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron*, 467 U.S. at 842-843. Under *Chevron* step 2, a court must defer to the agency's authoritative interpretation of an ambiguous statute "unless it is 'arbitrary or capricious in substance, or manifestly contrary to the statute.'" *Mayo Found.*, 562 U.S. at 53 (quoting *Household Credit Servs., Inc. v. Pfennig*, 541

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[12] The Supreme Court explained that "*Chevron* deference is appropriate 'when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.'" *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 57 (2011) (quoting *United States v. Mead Corp.*, 533 U.S. 218, 226-227 (2001)). The Supreme Court concluded that when Treasury issues general authority regulations after full notice and comment procedures, these conditions are met and those regulations are therefore entitled to *Chevron* deference. *See id.* at 56-57.

U.S. 232, 242 (2004)); *see also Judulang*, 565 U.S. at ___, 132 S. Ct. at 483 n.7.

Chevron deference applies even where an agency adopts a construction that conflicts with a prior judicial construction of the statute. *See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-983 (2005). However, if a precedential case holds that a statute unambiguously expresses a congressional intent that is contrary to the agency's construction of the statute, the prior judicial construction controls. *See id.*; *see also United States v. Home Concrete & Supply, LLC*, 566 U.S. ___, ___, 132 S. Ct. 1836, 1844 (2012).

D. Harmless Error

APA sec. 706 instructs reviewing courts to take "due account * * * of the rule of prejudicial error." *See also Nat'l Ass'n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644, 659-660 (2007) ("In administrative law, as in federal civil and criminal litigation, there is a harmless error rule[.]" (quoting *PDK Labs. Inc. v. DEA*, 362 F.3d 786, 799 (D.C. Cir. 2004))). This rule reflects the notion that "[i]f the agency's mistake did not affect the outcome, if it did not prejudice the petitioner, it would be senseless to vacate" the agency action. *PDK Labs.*, 362 F.3d at 799.

III. Preliminary Administrative Law Issues

The parties disagree whether the final rule is a legislative rule or an interpretive rule. The parties also disagree regarding the standard of review that we should apply. We therefore address these issues before considering the validity of the final rule.

A. APA Sec. 553 Applies to the Final Rule.

Petitioner contends that the final rule is a legislative rule under APA sec. 553(b) and is therefore subject to the notice and comment requirements of APA sec. 553 because, if valid, it would have the force of law. Alternatively, petitioner contends that if the final rule were an interpretive rule, it would "not have the force and effect of law", *Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87, 99 (1995), and therefore the final rule would not be binding on this Court. Respondent agrees that the final rule has the force of law but disagrees with petitioner's contention that it is a legislative rule. However, respondent declined to argue this issue on brief or at oral argument.

Instead, respondent contends that we need not decide this issue because Treasury complied with the notice and comment requirements. However, petitioner contends that Treasury failed to adequately explain the basis of the final rule, and Treasury's obligation to explain the basis of the final rule depends, at least in part, on its being a legislative rule subject to the notice and comment requirements of APA sec. 553. *See* APA sec. 553(c); *cf.* Internal Revenue Manual pt. 32.1.5.4.7.5.1(2) (Sept. 30, 2011) ("[M]ost IRS/Treasury regulations will be interpretative regulations because they fill gaps in legislation or have a prior existence in the law."); *id.* pt. 32.1.5.4.7.3(1) ("In the Explanation of Provisions section, the drafting team should describe the substantive provisions of the regulation in clear, concise, plain language * * * . It is not necessary to justify the rules that are being proposed or adopted or alternatives that were considered.").[13] Petitioner also contends that Treasury failed to respond

[13] The current version of Internal Revenue Manual pt. 32.1.5.4.7.3(1) (Oct. 20, 2014) omits the second sentence.

to significant comments, and Treasury's obligation to respond to significant comments is derived, at least in part, from the notice and comment requirements of APA sec. 553. *See Home Box Office*, 567 F.2d at 35-36. Moreover, we cannot avoid this issue because petitioner alternatively contends that the final rule would not bind this Court if it were an interpretive rule. Consequently, we will decide this issue.

Pursuant to section 7805(a) the Secretary is authorized to "prescribe all needful rules and regulations for the enforcement of" the Code. Such regulations carry the force of law, and the Code imposes penalties for failing to follow them. *See*, *e.g.*, sec. 6662(b)(1). We therefore conclude that "Congress has delegated legislative power to" Treasury. *Am. Mining Cong.*, 995 F.2d at 1109.

We further conclude that Treasury intended for the final rule to have the force of law for the following reasons: (1) the parties stipulated – and we agree, *see Xilinx Inc. v. Commissioner*, 125 T.C. 37 – that the adjustments to petitioner's income can be sustained only on the basis of the final rule, *see Hemp Indus.*, 333 F.3d at 1087, and (2) in promulgating the final rule Treasury invoked its general legislative rule-making authority under section 7805(a), *see id*. The final rule is therefore a legislative rule. *See Am. Mining Cong.*, 995 F.2d at 1109.

Because it is a legislative rule and Treasury did not find for good cause that notice and comment were impracticable, unnecessary, or contrary to the public interest, *see* APA sec. 553(b)(A) and (B), APA sec. 553 applies to the final rule. We must therefore also consider whether Treasury satisfied its obligations under APA sec. 553(b) and (c) in issuing the final rule.

B. The Final Rule Must Satisfy *State Farm*'s Reasoned Decisionmaking Standard.

Petitioner contends that we should review the final rule under *State Farm*. Respondent contends that we should review the final rule under *Chevron*. For the reasons that follow, we conclude that – regardless of the ultimate standard of review – the final rule must satisfy *State Farm'*s reasoned decisionmaking standard.

Respondent contends that *State Farm* review is not appropriate because the interpretation and implementation of section 482 do not require empirical analysis. Similarly, respondent repeatedly argues that section 482 does not require allocations to be made with reference to uncontrolled party conduct. But "[t]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. * * * The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394, 400 (1972) (quoting section 1.482-1(b)(1), Income Tax Regs. (1971)); *accord* sec. 1.482-1(a)(1), (b)(1), Income Tax Regs.; Treasury Department Technical Explanation of the 2001 U.S.-U.K. Income Tax Convention, art. 9; Treasury Department Technical Explanation of the 1997 U.S.-Ir. Income Tax Convention and Protocol, art. 9, Tax Treaties (CCH) para. 4435, at 103,223; Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, art. 9. For these reasons we have previously stated that "the determination under section 482 is essentially and intensely factual". *Procacci v. Commissioner*, 94 T.C. 397, 412 (1990).

Section 1.482-1(b)(1), Income Tax Regs., provides that "[i]n 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." In *Xilinx Inc. v. Commissioner*, 125 T.C. at 53-55, we held that the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances. Similarly, in promulgating the final rule Treasury explicitly considered whether unrelated parties would share stock-based compensation costs in the context of a QCSA. *See* T.D. 9088, 2003-2 C.B. at 843 ("Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation."). Treasury necessarily decided an empirical question when it concluded that the final rule was consistent with the arm's-length standard.

Respondent counters that Treasury should be permitted to issue regulations modifying – or even abandoning – the arm's-length standard. But the preamble to the final rule does not justify the final rule on the basis of any modification or abandonment of the arm's-length standard,[14] and respondent concedes

[14] For example, the preamble does not say that controlled transactions can never be comparable to uncontrolled transactions because related and unrelated parties always occupy materially different circumstances. *Cf. Xilinx Inc. v. Commissioner*, 598 F.3d at 1197 (Fisher, J., concurring) ("The Commissioner * * * contends that analyzing comparable transactions is unhelpful in

that the purpose of section 482 is to achieve tax parity.[15] The preamble also did not dismiss any of the evidence submitted by commentators regarding unrelated party conduct as addressing an irrelevant or inconsequential factor. *See id.*, 2003-2 C.B. at 842-843. We therefore need not decide whether, under *Brand X*, 545 U.S. at 982-983, Treasury would be free to modify or abandon the arm's-length standard because it has not done so here. *See Chenery Corp.*, 332 U.S. at 196; *Carpenter Family Invs., LLC v. Commissioner*, 136 T.C. at 380, 396 n.30.

The validity of the final rule therefore turns on whether Treasury reasonably concluded, *see State Farm*, 463 U.S. at 43, that it is consistent with the arm's-length standard, and that is necessarily an empirical determination. The reasonableness of Treasury's conclusion in no way depends on its interpretation of section 482 or any other statute. As the Supreme Court recently articulated, *State Farm* review is "the more apt analytic framework" where the challenged regulation does not rely on an agency's interpretation of a statute. *Judulang*, 565 U.S. at ___ n.7, 132 S. Ct. at 483.

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situations where related and unrelated parties always occupy materially different circumstances.").

[15] The preamble states that "Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances." T.D. 9088, 2003-2 C.B. 841, 842. However, the preamble never suggests that the final rule could be consistent with the arm's-length standard if evidence showed that unrelated parties would not share stock-based compensation costs or that an evidentiary inquiry was unnecessary. *See id.*, 2003-2 C.B. at 842-843.

Nevertheless, respondent contends that we should not review the final rule under *State Farm* because the Supreme Court has never, and this Court has rarely, reviewed Treasury regulations under *State Farm*. However, respondent concedes that Treasury is subject to the APA, and respondent has not advanced any justification for exempting Treasury regulations from *State Farm* review. The Supreme Court has stated that "[i]n the absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly '[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.'" *Mayo Found.*, 562 U.S. at 55 (quoting *Dickinson v. Zurko*, 527 U.S. 150, 154 (1999) (alteration in original)); *see also Dominion Res., Inc. v. United States*, 681 F.3d 1313, 1319 (Fed. Cir. 2012) (invalidating the associated-property rule in section 1.263A-11(e)(1)(ii)(B), Income Tax Regs., under *State Farm*).

Ultimately, however, whether *State Farm* or *Chevron* supplies the standard of review is immaterial because *Chevron* step 2[16] incorporates the reasoned decisionmaking standard of *State Farm*. *See Judulang*, 565 U.S. at ___ n.7, 132 S. Ct. at 483 (stating that, under either standard, the "analysis would be the same, because under *Chevron* step two, we ask whether an agency interpretation is 'arbitrary or capricious in substance'" (quoting *Mayo Found.*, 562 U.S. at 53)); *Torres-Valdivias v. Holder*, 766 F.3d 1106, 1114 n.5 (9th Cir. 2014) (citing *Judulang*, 565 U.S. at ll n.7, 132 S. Ct. at 483); *Agape Church, Inc. v.*

[16] The parties agree that sec. 482 is ambiguous. These cases would therefore be resolved at *Chevron* step 2.

FCC, 738 F.3d 397, 410 (D.C. Cir. 2013) (citing *Judulang*, 565 U.S. at ___ n.7, 132 S. Ct. at 483). Because the validity of the final rule turns on whether Treasury reasonably concluded that it is consistent with the arm's-length standard, the final rule must – in any event – satisfy *State Farm*'s reasoned decisionmaking standard. Accordingly, we will examine whether the final rule satisfies that standard without deciding whether *Chevron* or *State Farm* provides the ultimate standard of review.

IV. Whether the Final Rule Satisfies *State Farm*'s Reasoned Decisionmaking Standard

Petitioner contends that the final rule is invalid because (A) it lacks a basis in fact, (B) Treasury failed to rationally connect the choice it made with the facts it found, (C) Treasury failed to respond to significant comments, and (D) the final rule is contrary to the evidence before Treasury. Respondent disagrees.

A. The Final Rule Lacks a Basis in Fact.

Petitioner contends that the final rule lacks a basis in fact because Treasury issued the final rule without any evidence that unrelated parties would ever agree to share stock-based compensation costs. Respondent contends that (1) Treasury did not rely solely on its belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs but also on the commensurate-with-income standard and (2) Treasury was sufficiently experienced with cost-sharing agreements to conclude that unrelated parties entering into QCSAs would generally share stock-based compensation costs.

1. The Commensurate-With-Income Standard Cannot Justify the Final Rule.

Although Treasury referred to the commensurate-with-income standard in the preamble to the final rule, it relied on its belief that the final rule was required by – or was at least consistent with – the arm's-length standard.[17] In *Xilinx Inc. v. Commissioner*, 125 T.C. at 56-58, we concluded that Congress never intended for the commensurate-with-income standard to supplant the arm's-length standard. In the 1988 White Paper, Treasury and the IRS similarly concluded that Congress intended for the commensurate-with-income standard to work consistently with the arm's-length standard. *See* Notice 88-123, 1988-2 C.B. 458, 472, 475. Treasury has since repeatedly reinforced this conclusion in technical explanations to numerous income tax treaties.[18] *See*, *e.g.*, Treasury Department Technical Explanation of the 2001 U.S.-U.K. Income Tax Convention, art. 9, Tax Treaties

[17] In its response to comments asserting that stock-based compensation does not constitute an economic cost to the issuing corporation, Treasury appears to have relied *exclusively* on the arm's-length standard. *See* T.D. 9088, 2003-2 C.B. at 843 ("Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account in the context of QCSAs is appropriate. The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard.").

[18] "A tax treaty is negotiated by the United States with the active participation of the Treasury. The Treasury's reading of the treaty is 'entitled to great weight.'" *Xilinx Inc. v. Commissioner*, 598 F.3d at 1196-1197 (Noonan, J.) (quoting *United States v. Stuart*, 489 U.S. 353, 369 (1989)), *aff'g* 125 T.C. 37 (2005). Therefore, "[e]ven if the treaty and the Technical Explanation should be held not to operate as law trumping the hapless * * * [final rule], treaty and explanation act as guides. They tell us what the Treasury * * * had in mind", *Xilinx Inc. v. Commissioner*, 567 F.3d 482, 500-501 (9th Cir. 2009) (Noonan, J., dissenting), *rev'g and remanding* 125 T.C. 37, *withdrawn*, 592 F.3d 1017 (9th Cir. 2010), in issuing the final rule.

(CCH) para. 10,911, at 201,306-201,307; Treasury Department Technical Explanation of the 1997 U.S.-Ir. Income Tax Convention and Protocol, Tax Treaties (CCH) para. 4435, at 103,223; Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, art. 9, Tax Treaties (CCH) para. 215, at 10,640-10,641. The preamble to the final rule does not indicate that Treasury intended to abandon this conclusion and we conclude that it did not.[19]

Moreover, because Treasury did not rely *exclusively* on the commensurate-with-income standard, we cannot sustain the final rule solely on that basis if we decide that Treasury's reliance on the arm's-length standard in issuing the final rule was unreasonable. *See Chenery Corp.*, 332 U.S. at 196; *Nat'l Fuel Gas Supply*, 468 F.3d at 839 (citing *Allied-Signal*, 988 F.2d at 150-151, and *Consol. Edison*, 823 F.2d at 641-642). Accordingly, the commensurate-with-income standard, as interpreted by Treasury, cannot provide a sufficient basis for the final rule.

2. *Treasury's Unsupported Assertion Cannot Justify the Final Rule.*

A court will generally not override an agency's "reasoned judgment about what conclusions to draw from technical evidence or how to adjudicate between rival scientific [or economic] theories". *Tripoli Rocketry Ass'n v. Bureau of Alcohol, Tobacco, Firearms & Explosives*, 437 F.3d 75, 83 (D.C. Cir. 2006). However,

[19] Even were we to conclude that Treasury intended to adopt a more expansive understanding of the commensurate-with-income standard, we would be unable to sustain the final rule on that basis because Treasury never acknowledged that it was changing its position. *See FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) (citing *United States v. Nixon*, 418 U.S. 683, 696 (1974)).

"where an agency has articulated no reasoned basis for its decision – where its action is founded on unsupported assertions or unstated inferences – * * * [a court] will not 'abdicate the judicial duty carefully to "review the record to ascertain that the agency has made a reasoned decision based on reasonable extrapolations from some reliable evidence."'" *Id.* (quoting *Am. Mining Cong. v. EPA*, 907 F.2d 1179, 1187 (D.C. Cir. 1990)).

Respondent concedes that (1) in adopting the final rule, Treasury took the position that it was not obligated to engage in fact finding or to follow evidence gathering procedures; (2) the files maintained by Treasury relating to the final rule did not contain any empirical or other evidence supporting Treasury's belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs; (3) the files maintained by Treasury relating to the final rule did not have any record that Treasury searched any database that could have contained agreements between unrelated parties; and (4) Treasury was unaware of any written agreement – or of any transaction – between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation.[20]

The preamble to the final rule offered only Treasury's belief that unrelated parties entering into

[20] Treasury's failure to conduct any factfinding before issuing the final rule is also evident in the preamble to the final rule. *See* T.D. 9088, 2003-2 C.B. at 842 ("While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs *such data may not be available*." (Emphasis added.)).

QCSAs would generally share stock-based compensation costs. Specifically, the preamble to the final rule states that, in the context of a hypothetical QCSA between unrelated parties to develop patentable pharmaceutical products, "Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation." T.D. 9088, 2003-2 C.B. at 843. Treasury, however, failed to provide a reasoned basis for reaching this conclusion from any evidence in the administrative record. *See Tripoli Rocketry*, 437 F.3d at 83. Indeed, "every indication in the record points the other way". *State Farm*, 463 U.S. at 57 (internal quotation omitted); *see infra* part IV.C.

Respondent defends Treasury's failure to provide a reasoned basis for its conclusion from any evidence in the administrative record on the notion that "[t]here are some propositions for which scant empirical evidence can be marshaled". *See Fox Television*, 556 U.S. at 519. This may be true regarding certain propositions, *see id*. ("the harmful effect of broadcast profanity on children is one of them"), but we do not agree that the belief that unrelated parties would share stock-based compensation costs in the context of a QCSA is one of them. First, commentators submitted significant evidence regarding this proposition. *See infra* part IV.C. Second, we were able to reach a definitive factual determination on the basis of significant evidence regarding this very proposition in *Xilinx*. *See Xilinx Inc. v. Commissioner*, 125 T.C. at 58-62. Third, Treasury could not have rationally concluded that this is a proposition "for which scant empirical evidence can be marshaled", *see Fox Television*, 556 U.S. at 519, without attempting to marshal empirical evidence in the first instance, which respondent concedes it did not do.

Relying on *Peck v. Thomas*, 697 F.3d 767 (9th Cir. 2012), respondent further contends that we must defer to Treasury's expertise with respect to whether the parties operating at arm's length would share stock-based compensation. At issue in *Peck* was a regulation issued by the Bureau of Prisons that denied early release to inmates with a felony conviction for certain enumerated offenses. In issuing the regulation the Bureau of Prisons expressly relied on its "correctional experience'" in determining which offenses warrant preclusion from early release but did not disclose any statistical studies to support its conclusions. *See id.* at 773 (quoting 74 Fed. Reg. 1895 (Jan. 14, 2009)). The U.S. Court of Appeals for the Ninth Circuit rejected an inmate's argument that the Bureau of Prisons violated the APA in issuing this regulation because it did not develop statistical evidence to support its conclusions. *See id.* at 775-776. The Court of Appeals reasoned that the Bureau of Prisons was entitled to rely on its experience and the APA did not require it to develop statistical evidence to support its conclusions. *See id.* (citing *Sacora v. Thomas*, 628 F.3d 1059, 1067, 1069 (9th Cir. 2010)).

Respondent's reliance on *Peck* is misplaced. First, in *Peck*, the Bureau of Prisons relied on its extensive correctional experience in determining which offenses warrant preclusion from early release. Here, by contrast, Treasury admits that it had no knowledge of any transactions in which parties operating at arm's length shared stock-based compensation.

Second, the preamble to the regulation at issue in *Peck* expressly relied on the Bureau of Prisons' extensive, hands-on correctional experience. Here, by contrast, the preamble to the final rule does not rely on Treasury's experience as a party to arm's-length cost-sharing agreements – or even on any experience Treasury may have had in examining the arm's-length cost-sharing agreements of taxpayers it regulates. Indeed, the preamble to the final rule all but disclaimed Treasury's reliance on any such experience.

Third, the administrative record for the regulation at issue in *Peck* contained no evidence contradicting the Bureau of Prisons' correctional experience. Here, by contrast, commentators introduced significant evidence showing that parties operating at arm's length would not share stock-based compensation. *See infra* part IV.C. *Peck* does not support the contention that an agency can rely on unsupported assertions in the face of significant contrary evidence in the administrative record.

We conclude that (1) by failing to engage in any fact finding, Treasury failed to "examine the relevant data", *State Farm*, 463 U.S. at 43, and (2) Treasury failed to support its belief that unrelated parties would share stock-based compensation costs in the context of a QCSA with any evidence in the record. Accordingly, the final rule lacks a basis in fact.

B. Treasury Failed To Rationally Connect the Choice It Made With the Facts It Found.

Petitioner contends that the preamble to the final rule fails to rationally connect the choice that Treasury made in issuing a uniform final rule with the facts on which it purported to rely. *See id.* The preamble to the final rule indicates that Treasury relied on its belief that unrelated parties entering into QCSAs to develop "high-profit intangibles" would share stock-based compensation if the stock-based compensation was a "significant element" of the compensation. T.D. 9088, 2003-2 C.B. at 842-843. However, petitioner alleges, and respondent does not dispute, that (1) many QCSAs do not deal with "high-profit intangibles" and (2) stock-based compensation is often not a "significant element" of the compensation of the employees of taxpayers that enter into QCSAs. Yet the final rule does not distinguish between QCSAs to develop "high-profit intangibles" in which stock-based compensation was a "significant element" of the compensation and QCSAs in which these elements are not present. Petitioner contends – and we agree – that the preamble's explanation for Treasury's decision is therefore inadequate. *See State Farm*, 463 U.S. at 43.

Indeed, respondent does not directly refute petitioner's contention. Instead, respondent defends the final rule's inflexibility by arguing that the final rule is reasonable because it eases administrative burdens.[21]

Improving administrability can be a reasonable basis for agency action. *See Mayo Found.*, 562 U.S. at 59 ("[Treasury] reasonably concluded that its full-time employee rule would 'improve administrability[.]'" (quoting T.D. 9167, 2005-1 C.B. 261, 262)). However,

[21] Respondent also argues that petitioner cannot complain if the final rule sometimes produces results that are inconsistent with the arm's-length standard because the QCSA regime provides an "elective assured treatment". However, Treasury rejected commentators' suggestion to issue the final rule as a safe harbor, *see* T.D. 9088, 2003-2 C.B. at 843-844, and we conclude that petitioner has not forfeited its right to challenge the validity of the final rule because it chose to structure the R&D cost-sharing agreement as a QCSA.

Treasury failed to give this – or any other – explanation for treating all QCSAs identically in the preamble to the final rule,[22] *cf. id.*, and we cannot reasonably discern, *see State Farm*, 463 U.S. at 43, that this was Treasury's rationale for adopting a uniform final rule because the administrative benefits of a uniform final rule are entirely speculative.[23]

Moreover, even if we could discern that this was Treasury's intent, we would be unable to sustain the final rule on that basis because Treasury did not disclose its factual findings and we would therefore be unable to evaluate whether Treasury reasonably concluded that the purported administrative benefits of a uniform final rule can justify erroneously allocating income in some of those cases. We therefore conclude that, by treating all QCSAs identically, Treasury failed to articulate a "rational connection between the facts found and the choice made." *State Farm*, 463 U.S. at 43 (quoting *Burlington Truck Lines*, 371 U.S. at 168).

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[22] The preamble to the final rule discusses administrability only with respect to Treasury's selection of the exercise spread method and the elective grant date method as the only available valuation methods. *See* T.D. 9088, 2003-2 C.B. at 844.

[23] We also note that unlike the statutory provision at issue in *Mayo Found.*, sec. 482 purports only to empower the Secretary to allocate income among controlled entities but not to directly govern taxpayer conduct. *See* sec. 1.482-1(a)(3), Income Tax Regs. ("If necessary to reflect an arm's length result, a controlled taxpayer *may* report * * * the results of its controlled transactions based upon prices different from those actually charged." (Emphasis added.)). It is accordingly unclear whether administrability concerns are relevant in the context of sec. 482. However, because we cannot reasonably discern that Treasury relied on administrability concerns here, we need not resolve this question.

C. Treasury Failed To Respond to Significant Comments.

Petitioner contends that Treasury failed to respond to significant comments submitted by commentators. Respondent contends that Treasury was not persuaded by the submitted comments.

Several commentators informed Treasury that they knew of no evidence of any transaction between unrelated parties that required one party to reimburse the other party for amounts attributable to stock-based compensation. Additionally, AeA informed Treasury that a survey of its member companies' arm's-length codevelopment and joint venture agreements found none in which the parties agreed to share stock-based compensation costs. We found similar evidence to be relevant in *Xilinx*. *See Xilinx Inc. v. Commissioner*, 125 T.C. at 59. Treasury never directly responded to this evidence. Instead, Treasury reasoned that the final rule would not be inconsistent with the arm's-length standard in the absence of evidence that unrelated parties share stock-based compensation costs because relevant data may not be available. *See* T.D. 9088, 2003-2 C.B. at 842. Treasury's response, however, in no way refutes the commentators' evidence that unrelated parties never share such compensation.

AeA and PwC further represented to Treasury that they conducted multiple searches of the EDGAR system and found no cost-sharing agreements between unrelated parties in which the parties agreed to share either the exercise spread or grant date value of stock-based compensation. Treasury never responded to this evidence.

Several commentators identified arm's-length agreements in which stock-based compensation was not shared or reimbursed. Treasury responded to these comments by stating that "[t]he 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." *Id.* In particular, Treasury stated that

> [t]he other agreements highlighted by commentators establish arrangements that differ significantly from QCSAs in that they provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement. Such terms, which may have the effect of mitigating the impact of using a cost base to be shared or reimbursed that is less than comprehensive, would not be permitted by the QCSA regulations. * * * [*Id.*]

However, the Amylin-HMR collaboration agreement that AeA identified and PwC submitted did not "provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement." *Id.* Respondent contends that the Amylin-HMR collaboration agreement is not comparable to a QCSA for other reasons, but Treasury failed to identify those reasons in the preamble to the final rule.[24] *See Chenery Corp.*, 332 U.S.

[24] The Amylin-HMR collaboration agreement also would permit the sharing of stock-based compensation based on the intrinsic value method, under which options issued in-the-money would be recognized as an expense. However, the treatment of in-the-

at 196; *Carpenter Family Invs., LLC v. Commissioner*, 136 T.C. at 380, 396 n.30. More significantly, Treasury did not explain why identical transactions are necessary to prove whether unrelated parties would share stock-based compensation costs in the context of a QCSA. In *Xilinx Inc. v. Commissioner*, 125 T.C. at 58-62, we found that unrelated parties would not share the exercise spread or grant date value of stock-based compensation, and in doing so we did not rely on transactions that were identical or substantially similar to QCSAs. Rather, we relied on the behavior of uncontrolled parties in comparable business transactions as well as on other evidence. *See id.*[25]

FEI provided model accounting procedures from COPAS that recommended against sharing stock-based compensation because it is difficult to value. Treasury never responded to this evidence.

AeA, SoFTEC, KPMG, and PwC cited regulations that prohibit contractors from charging the Federal Government for stock-based compensation. Treasury responded to this evidence by stating that "[g]overnment contractors that are entitled to reimbursement for services on a cost-plus basis under government procurement law assume substantially less entrepreneurial risk than that assumed by service providers that participate in QCSAs". *See* T.D. 9088, 2003-2 C.B. at 842. However, this distinction rings hollow in the face of other evidence submitted by commentators that showed that even parties to agreements in which

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money stock options is not at issue here, and the final rule explicitly rejected the use of the intrinsic value method. *See* T.D. 9088, 2003-2 C.B. at 844.

[25] Treasury appears to require a similar approach in analyzing comparability under the sec. 482 regulations. *See* sec. 1.482-1(d), Income Tax Regs.

the parties assume considerable entrepreneurial risk do not share stock-based compensation costs.

AeA, Global, and PwC explained that, from an economic perspective, unrelated parties would be unwilling to share stock-based compensation costs because the value of stock-based compensation is speculative, potentially large, and completely outside the control of the parties. SoFTEC submitted Baumol and Malkiel's detailed economic analysis reaching the same conclusion. We found similar evidence to be relevant in *Xilinx*. *See Xilinx Inc. v. Commissioner*, 125 T.C. at 61. Treasury never directly responded to this evidence. Instead, Treasury construed these comments as objections to Treasury's selection of the exercise spread method and the grant date method as the only available valuation methods. *See* T.D. 9088, 2003-2 C.B. at 844. Treasury responded that these methods are consistent with the arm's-length standard and are administrable. *See id.* Treasury, however, never explained how these methods could be consistent with the arm's-length standard if unrelated parties would not share them or why unrelated parties would share stock-based compensation costs in any other way.

The Baumol and Malkiel analysis also concluded that there is no net economic cost to a corporation or its shareholders from the issuance of stock-based compensation. Treasury identified this evidence in the preamble to the final rule but did not directly respond to it. *See id.*, 2003-2 C.B. at 843. Instead, the preamble states that "[t]he final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard." *Id.* Treasury, however, never explained why unrelated parties would share stock-based compensation costs – or how the commensurate-with-income standard could justify the final rule – if stock-based compensation is not an economic cost to the issuing corporation or its shareholders.[26]

Mr. Grundfest informed Treasury that companies do not factor stock-based compensation into their pricing decisions. We found similar evidence to be relevant in *Xilinx*. *See Xilinx Inc. v. Commissioner*, 125 T.C. at 59. Treasury never responded to this evidence.

Indeed, Treasury failed to respond directly to any of the evidence that unrelated parties would not share stock-based compensation costs, other than by asserting that the transactions cited by the commentators did not "share enough characteristics of QCSAs involving the development of high-profit intangibles" to be relevant. T.D. 9088, 2003-2 C.B. at 842. This was a mere assertion; Treasury offered no analysis addressing the extent of the supposed differences or explaining why any differences make the cited transactions irrelevant or unpersuasive. By contrast, in *Xilinx* we examined a broad array of evidence to determine whether unrelated parties would share such costs. *See Xilinx Inc. v. Commissioner*, 125 T.C. at 58-62. Tellingly, respondent does not even attempt to explain why Treasury failed to address similar evidence in the preamble to the final rule.

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[26] Respondent contends that the final rule is consistent with the commensurate-with-income standard because stock-based compensation is economic activity even if it is not an economic cost. However, Treasury never made this distinction in the preamble to the final rule, *see SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947); *Carpenter Family Invs., LLC v. Commissioner*, 136 T.C. 373, 380, 396 n.30 (2011), and it did not explain why unrelated parties would share items that are not economic costs.

Although Treasury's failure to respond to an isolated comment or two would probably not be fatal to the final rule, Treasury's failure to meaningfully respond to numerous relevant and significant comments certainly is. *See Home Box Office*, 567 F.2d at 35-36. Meaningful judicial review and fair treatment of affected persons require "an exchange of views, information, and criticism between interested persons and the agency." *Id*. at 35. Treasury's failure to adequately respond to commentators frustrates our review of the final rule and was prejudicial to affected entities.

D. The Final Rule Is Contrary to the Evidence Before Treasury.

Petitioner contends that the final rule is contrary to the evidence before Treasury when it issued the final rule. We agree.

We have already discussed Treasury's failure to cite any evidence supporting its belief that unrelated parties to QCSAs would share stock-based compensation costs, *see supra* part IV.A; the significant evidence submitted by commentators showing that unrelated parties to QCSAs would not share stock-based compensation costs, *see supra* part IV.C; and Treasury's failure to respond to much of the submitted evidence, *see id*.

Significantly, Treasury never said that it found any of the submitted evidence incredible. Treasury also seemed to accept the commentators' economic analyses, which concluded that – and explained why – unrelated parties to a QCSA would be unwilling to share the exercise spread or grant date value of stock-based compensation. Finally, respondent has not identified any evidence in the administrative record that supports Treasury's belief that unrelated parties to QCSAs would generally share stock-based compensation costs.

Although we are mindful that "a court is not to substitute its judgment for that of the agency", *State Farm*, 463 U.S. at 43, we conclude that Treasury's "explanation for its decision * * * runs counter to the evidence before" it, *see id.*

V. Harmless Error

Respondent contends that, pursuant to the harmless error rule of APA sec. 706, any deficiencies in Treasury's reasoning should not invalidate the final rule because (1) Treasury had sufficient alternative reasons for adopting the final rule and (2) in the years following Treasury's adoption of the final rule the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the Organisation for Economic Cooperation and Development (OECD)[27] have adopted policy positions that concur with Treasury's.[28]

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[27] In 2004 the OECD published a report on the impact of employee stock options on transfer pricing that "start[ed] with the premise that employee stock options are remuneration." OECD, Employee Stock Option Plans: Impact on Transfer Pricing 1. In 2005, however, the OECD published a policy study that again started with the same premise but recognized that the arm's-length standard required more analysis. *See* OECD, The Taxation of Employee Stock Options, Tax Policy Studies No. 11, at 165 ("Of course, whether in-kind remuneration, including stock options, should be taken into account in any particular case depends on a determination of what independent parties acting at arm's length would do in the facts and circumstances of that case.").

[28] Each of the policy positions that respondent now contends support the 2003 final rule was published *after* Treasury promulgated the final rule. *See*, *e.g.*, Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation

A. Alternative Reasons for Adopting the Final Rule

Although the preamble refers to the commensurate-with-income standard, we have already concluded that Treasury never indicated that it was prepared to independently rely on the commensurate-with-income standard – or any other reason – as a basis for adopting the final rule. *See supra* parts III.B and IV.A.1. Moreover, because the arm's-length standard is incorporated into numerous income tax treaties, *see*, *e.g.*, 2001 U.S.-U.K. Income Tax Convention, art. 9; 2006 U.S. Model Income Tax Convention, art. 9; Treasury Department Technical Explanation of the 2001 U.S.-U.K. Income Tax Convention, art. 9, Tax Treaties (CCH) para. 10,911, at 201,306-201,307; Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, art. 9; Tax Treaties (CCH) para. 215, at 10,640-10,641, respondent cannot reasonably contend that Treasury would have clearly adopted the final rule had it concluded that the final rule conflicted with that standard. *See PDK Labs.*, 362 F.3d at 799.

B. Settled Policy

Respondent's argument that the policy debate underlying the final rule has long been settled is irrelevant and misapprehends the role of this Court under *State Farm*. It is irrelevant because Treasury expressly disavowed reliance on financial reporting standards when it issued the final rule, *see* T.D. 9088, 2003-2 C.B. at 843 ("Treasury and the IRS agree that

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(revised 2004), Share-Based Payment; International Financial Reporting Standard No. 2, Share-based Payment, February 2004; OECD, Employee Stock Option Plans: Impact on Transfer Pricing; *see also* OECD, the Taxation of Employee Stock Options, OECD Tax Policy Studies No. 11.

the disposition of financial reporting issues does not mandate a particular result under these regulations."), and the policy positions to which respondent refers did not exist and were therefore unavailable to Treasury when it issued the final rule, *see Chenery Corp.*, 332 U.S. at 196; *Carpenter Family Invs., LLC v. Commissioner*, 136 T.C. at 380, 396 n.30. Respondent's argument misapprehends the role of this Court because, under *State Farm*, our role is not to decide whether the final rule is good policy – it is simply to "ensur[e] that * * * [Treasury] engaged in reasoned decision-making." *Judulang*, 565 U.S. at ___, 132 S. Ct. at 483-484. Because it is not clear that Treasury would have adopted the final rule had it concluded that the final rule is inconsistent with the arm's-length standard, the harmless error rule is inapplicable.

VI. Conclusion

Because the final rule lacks a basis in fact, Treasury failed to rationally connect the choice it made with the facts found, Treasury failed to respond to significant comments when it issued the final rule, and Treasury's conclusion that the final rule is consistent with the arm's-length standard is contrary to all of the evidence before it, we conclude that the final rule fails to satisfy *State Farm*'s reasoned decisionmaking standard and therefore is invalid.[29] *See* APA sec.

[29] Because we conclude that the final rule fails to satisfy *State Farm*'s reasoned decisionmaking standard, the final rule would be invalid even if we were to conclude that *Chevron* supplies the ultimate standard of review. *See supra* part III.B. The analysis under *Chevron* would proceed as follows: The parties agree that sec. 482 is ambiguous. We would therefore proceed to *Chevron* step 2. Under *Chevron* step 2, we would conclude the final rule is invalid because it is "arbitrary or capricious in substance",

706(2)(A); *State Farm*, 463 U.S. at 43. Indeed, Treasury's "*ipse dixit* conclusion, coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decisionmaking." *Ill. Pub. Telecomms. Ass'n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1997).

By reason of the above respondent erred in making the section 482 allocations at issue, and petitioner is therefore entitled to partial summary judgment. We will grant petitioner's motion and deny respondent's motion.

We have considered the parties' remaining arguments, and to the extent not discussed above, conclude those arguments are irrelevant, moot, or without merit.

To reflect the foregoing,

An appropriate order will be issued.

Reviewed by the Court.

Thornton, Colvin, Halpern, Foley, Vasquez, Gale, Goeke, Holmes, Paris, Kerrigan, Buch, Lauber, Nega, and Ashford, *JJ.*, agree with this opinion of the Court.

Morrison and Pugh, *JJ.*, did not participate in the consideration of this opinion.

Judulang v. Holder, 565 U.S. ___, ___ n.7, 132 S. Ct. 476, 483 (2011) (quoting *Mayo Found.*, 562 U.S. at 53), and therefore cannot be justified as being a reasonable interpretation of what sec. 482 requires.

APPENDIX C

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Altera Corporation & Subsidiaries, *Petitioner-Appellee*, v. Commissioner of Internal Revenue, *Respondent-Appellant*.	Nos. 16-70496, 16-70497 Tax Ct. Nos. 6253-12, 9963-12 ORDER

Filed November 12, 2019

Before: Sidney R. Thomas, Chief Judge, and Susan P. Graber and Kathleen M. O'Malley,* Circuit Judges.

Order;
Dissent by Judge Milan D. Smith, Jr.

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* The Honorable Kathleen M. O'Malley, United States Circuit Judge for the U.S. Court of Appeals for the Federal Circuit, sitting by designation.

SUMMARY[**]

Tax

The panel denied a petition for rehearing en banc on behalf of the court in a case in which the panel reversed the decision of the Tax Court.

Judge M. Smith, joined by Judges Callahan and Bade, dissented from the denial of rehearing en banc. Title 26 of United States Code § 482 authorizes the Department of Treasury to re-allocate reported income and costs between related entities where necessary to prevent them from improperly avoiding taxes. Judge M. Smith agreed with the Tax Court's unanimous conclusion that the Treasury's implementing regulation § 1.482-7(d)(2) constituted arbitrary and capricious rulemaking in violation of the Administrative Procedure Act. Judge M. Smith observed that, in addition to being wrongly decided, the majority's decision engenders deleterious practical consequences, threatens the uniform enforcement of the Tax Code, invites an effective circuit split, ignores the reasonable reliance of businesses on the well-settled arm's length standard and subjects those businesses to double taxation, lowers the bar for compliance with the Administrative Procedure Act, and sends a signal that executive agencies can bypass proper notice-and-comment procedures through post-hoc rationalization.

[**] This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

COUNSEL

Arthur T. Catterall (argued), Richard Farber, Gilbert S. Rothenberg, and Francesca Ugolini, Attorneys; Travis A. Greaves, Deputy Assistant Attorney General; Richard E. Zuckerman, Principal Deputy Assistant Attorney General; Tax Division, United States Department of Justice, Washington, D.C.; for Respondent-Appellant.

Donald M. Falk (argued), Mayer Brown LLP, Palo Alto, California; Thomas Kittle-Kamp and William G. McGarrity, Mayer Brown LLP, Chicago, Illinois; Brian D. Netter, Travis Crum, and Nicole A. Saharsky, Mayer Brown LLP, Washington, D.C.; A. Duane Webber, Phillip J. Taylor, and Joseph B. Judkins, Baker & McKenzie LLP, Washington, D.C.; Ginger D. Anders, Munger Tolles & Olson LLP, Washington, D.C.; Mark R. Yohalem, Munger Tolles & Olson LLP, Los Angeles, California; for Petitioner-Appellee.

Susan C. Morse, University of Texas Law School, Austin, Texas; Stephen E. Shay and Allison Bray, Certified Law Students, Harvard Law School, Cambridge, Massachusetts; Clinton G. Wallace, Columbia, South Carolina; and Leandra Lederman, Bloomington, Indiana; for Amici Curiae Law Academics and Professors.

Jonathan E. Taylor, Gupta Wessler PLLC, Washington, D.C.; Clint Wallace, Vanderbilt Hall, New York, New York; for Amici Curiae Anne Alstott, Reuven Avi-Yonah, Lily Batchelder, Joshua Blank, Noel Cunningham, Victor Fleischer, Ari Glogower, David Kamin, Mitchell Kane, Sally Katzen, Edward Kleinbard, Michael Knoll, Rebecca Kysar, Zachary Liscow, Daniel Shaviro, John Steines, David Super, Clint Wallace, and George Yin.

Larissa B. Neumann, Ronald B. Schrotenboer, Kenneth B. Clark, Adam R. Gahtan, and Michael D. Knobler, Fenwick & West LLP, Mountain View, California, for Amicus Curiae Xilinx Inc.

Christopher J. Walker, The Ohio State University Moritz College of Law, Columbus, Ohio; Kate Comerford Todd, Steven P. Lehotsky, and Warren Postman, U.S. Chamber Litigation Center, Washington, D.C.; for Amicus Curiae Chamber of Commerce of the United States of America.

John I. Forry, San Diego, California, for Amicus Curiae TechNet.

Charles G. Cole, Alice E. Loughran, Michael C. Durst, Gregory N. Kidder, and Mark C. Savignac, Steptoe & Johnson LLP, Washington, D.C.; Bennett Evan Cooper, Steptoe & Johnson LLP, Phoenix, Arizona; Alexander Volokh, Emory University School of Law, Atlanta, Georgia; for Amici Curiae Software and Information Industry Association, Financial Executives International, Information Technology Industry Council, Silicon Valley Tax Directors Group, Software Finance and Tax Executives Counsel, National Association of Manufacturers, American Chemistry Council, BSA | the Software Alliance, National Foreign Trade Council, Biotechnology Innovation Organization, Computing Technology Industry Association, The Tax Council, United States Council for International Business, and Semiconductor Industry Association.

Kenneth P. Herzinger and Eric C. Wall, Orrick Herrington & Sutcliffe LLP, San Francisco, California; Peter J. Connors, Orrick Herrington & Sutcliffe LLP, New York, New York; for Amici Curiae Charles W. Calomiris, Kevin H. Hassett, and Sanjay Unni.

Roderick K. Donnelly and Neal A. Gordon, Morgan Lewis & Bockius LLP, Palo Alto, California; Thomas M. Peterson, Morgan Lewis & Bockius LLP, San Francisco, California; Michelle L. Andrighetto, Morgan Lewis & Bockius LLP, Boston, Massachusetts; Justin McGough, 3M Company, Saint Paul, Minnesota; Karen Robinson, Vice President, Legal, Adobe Inc., San Jose, California; Theodore J. Boutrous Jr. and Christopher Chorba, Gibson Dunn & Crutcher LLP (for Apple Inc.), Los Angeles, California; Armin D. Eberhard, Director, International Tax Planning and M&A, Applied Materials, Santa Clara, California; Desiree Ralls-Morrison, SVP, General Counsel & Corporate Secretary, Boston Scientific Corporation, Marlborough, Massachusetts; Thomas J. Vallone, Senior Vice President, Global Tax, Dell Technologies Inc., Round Rock, Texas; Andy Sherman, Dolby Laboratories Inc., San Francisco, California; Aaron Johnson, VP Legal, eBay, San Jose, California; Jacob Schatz, EVP, General Counsel and Corporate Secretary, Electronic Arts Inc., Redwood City, California; Katie Lodato, Vice President – Global Tax, Eli Lilly and Company, Indianapolis, Indiana; Dana L. Lasley, Emerson Electric Co., St. Louis, Missouri; Paul S. Grewal, VP & Deputy General Counsel, Facebook Inc., Menlo Park, California; John Whittle, Executive Vice President, General Counsel, Fortinet, Sunnyvale, California; Christine Henninger, General Mills Inc., Golden Valley, Minnesota; Nora Puckett, Google LLC, Mountain View, California; Kyle Bonacum, GoPro Inc., San Mateo, California; Joshua Mishoe, Vice President, Hewlett Packard Enterprise Company, Plano, Texas; Barbara Beckerman, International Paper Company, Memphis, Tennessee; Michael R. Peterson, President and Corporate Secretary, Johnson Controls Inc.; Mark Casper, Vice President and Deputy General Counsel, Maxim Integrated, San Jose, California; Matthew Fawcett, General Counsel, NetApp Inc., Sunnyvale, California; Margaret C. Wilson, Wilson Law Group LLC (for Oracle Corporation), Princeton, New Jersey; Maryanne Bifulco, Vice President, Transfer Pricing Counsel, PepsiCo Inc., Purchase, New York; Markus Green, Assistant GC, Government Relations/Litigation, Pfizer Inc., New York, New York; Lowell Yoder, McDermott Will & Emery (for Procter and Gamble Company), Chicago, Illinois; Beth Wapner, VP Tax, Qualcomm Incorporated, San Diego, California; Tanya Guazzo, S&P Global Inc., New York, New York; Russell Elmer, ServiceNow Inc., Santa Clara, California; Lora Blum, General Counsel, SurveyMonkey, San Mateo, California; Scott C. Taylor, EVP, General Counsel & Secretary, Symantec Corporation, Mountain View, California; Donald P. Lancaster, United Parcel Service Inc., Atlanta, Georgia; Lisa McFall, VP & Deputy General Counsel, Workday Inc., Pleasanton, California; for Amicus Curiae Cisco Systems Inc. and Thirty-Two Other Affected Companies.

Christopher Bowers, David Foster, Raj Madan, and Royce Tidwell, Skadden Arps Slate Meagher & Flom LLP, Washington, D.C.; Nathaniel Carden, Skadden Arps Slate Meagher & Flom LLP, Chicago, Illinois; for Amicus Curiae Amazon.com Inc.

Miriam L. Fisher, Melissa Arbus Sherry, and Eric J. Konopka, Latham & Watkins LLP, Washington, D.C., for Amici Curiae PricewaterhouseCoopers LLP, Deloitte Tax LLP, and KPMG LLP.

ORDER

The full court has been advised of the petition for rehearing en banc. A judge requested a vote on whether to rehear the matter en banc. The matter failed to receive a majority of the votes of the non-recused active judges in favor of en banc consideration. Fed. R. App. P. 35. Judges McKeown, Wardlaw, Bybee, Bea, Watford, Owens, Friedland, Miller, Collins, and Lee were recused and did not participate in the vote.

The petition for rehearing en banc is denied. Attached is the dissent from and statements respecting the denial of rehearing en banc.

M. SMITH, Circuit Judge, with whom CALLAHAN and BADE, Circuit Judges, join, dissenting from the denial of rehearing en banc:

Neither the laudable goal of preventing tax evasion nor the prospect of adding billions of dollars to the public coffers excuses the Department of the Treasury from complying with the Administrative Procedure Act. In 2003, Treasury promulgated a tax rule with no reasoned basis for its decision, pursuant to an explanation that ran contrary to the evidence before it. In 2019, a divided panel of our court upheld that rule based on a novel interpretation of the relevant statute, which Treasury developed only as an appellate litigating position, and which was never subject to notice and comment. As recognized by the unanimous en banc Tax Court, Treasury's actions in this case are the epitome of arbitrary and capricious rulemaking. The panel majority's decision tramples on the reliance interests of American businesses, threatens the uniform enforcement of the Tax Code, and drastically lowers the bar for compliance with the Administrative Procedure Act.

I respectfully dissent from our court's denial of rehearing en banc.[1]

I.

For almost a century, Congress has authorized Treasury to recalculate the taxes of related entities based on what their taxes would look like if they were unrelated entities. For the past fifty years, Treasury has made this determination by analyzing whether the results of a transaction between related entities are consistent with the results of a comparable transaction between entities operating at arm's length. When a transaction does not meet this arm's length standard, Treasury adjusts it for tax purposes by re-allocating the related entities' costs and income.

In the late-1990s, Treasury decided that stock-based compensation – then a new phenomenon – was a type of cost it wanted to re-allocate under these calculations. The problem was, and remains, that unrelated entities do not share stock-based compensation costs. Treasury's first attempt at such a re-allocation was therefore thrown out by the Tax Court and by this court because it was contrary to Treasury's own regulations calling for application of the arm's length standard. Perhaps preemptively recognizing this defect on the very face of its rules, Treasury attempted a mid-litigation cure of simply adding a cross reference to its arm's length standard provision. That attempted cure is the 2003 rulemaking challenged here.

[1] Judges McKeown, Wardlaw, Bybee, Bea, Watford, Owens, Friedland, Miller, Collins, and Lee were recused from consideration of en banc rehearing in this matter.

A.

In 1928, Congress enacted 26 U.S.C. ("I.R.C.") § 482 to authorize Treasury to re-allocate reported income and costs between related entities where necessary to prevent them from improperly avoiding taxes by, for instance, shifting income to lower tax foreign jurisdictions. *See* H.R. Rep. No. 70-2, at 16-17 (1927); *Comm'r v. First Sec. Bank of Utah, N.A.*, 405 U.S. 394, 400 (1972). Treasury soon promulgated regulations specifying that "[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. 86, art. 45-1(b) (1935).[2]

In 1968, Treasury promulgated regulations specific to "qualified cost-sharing arrangements" (QCSAs)[3], such as the research and development agreement at issue in this case. See 33 Fed. Reg. 5848 (April 16, 1968). Treasury required that, "[i]n order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement." *Id.* at 5854. The arm's length standard thus requires an "essen-

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[2] An "uncontrolled" taxpayer is distinguished from a "controlled" taxpayer, defined as "any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, . . . includ[ing] the taxpayer that owns or controls the other taxpayers." Treas. Reg. § 1.482-1(i)(5).

[3] Designation of a cost-sharing agreement as a QCSA allows participating entities to share the costs of developing intangible property without incurring partnership taxation, and without any foreign participants incurring taxes for doing business in the United States. Treas. Reg. § 1.482-7A(a)(1).

tially and intensely factual" inquiry that looks to comparable transactions between non-related entities to ensure tax parity. *Procacci v. Comm'r*, 94 T.C. 397, 412 (1990).

In 1986, Congress amended § 482 to address the valuation of *transfers* of intangible property,[4] providing that "[i]n 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." I.R.C. § 482. This amendment appeared to introduce a new standard for allocating costs – a "commensurate with income" standard – which might have constituted a departure from the traditional arm's length analysis. But soon after, in 1988, Treasury dispelled such notions by publishing what came to be known as the "White Paper." *See A Study of Intercompany Pricing Under Section 482 of the Code*, I.R.S. Notice 88-123, 1988-2 C.B. 458. The phrase "arm's length standard" appears throughout the White Paper, which reiterated that "intangible income *must be allocated on the basis of comparable transactions* if comparables exist." *Id*. at 474 (emphasis added). In short, although the amended § 482 referenced a seemingly unfamiliar "commensurate with income" standard, the White Paper emphasized that "Congress intended no departure

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[4] At the time the regulation challenged in this case was promulgated, "intangible property" was defined by a list of items that included any "patent, invention, formula, process, design, pattern, or know-how," "copyright," "trademark," "license," and so forth. I.R.C. § 936(h)(3)(B) (1996). In 2017, Congress amended the definition to include "goodwill, going concern value, . . . workforce in place," and other items whose value is "not attributable to tangible property or the services of any individual." I.R.C. § 367(d)(4).

from the arm's length standard" – which is to say, an analysis based on comparability. *Id*. at 475.[5]

B.

In 1995, Treasury promulgated a regulation requiring participants in a QCSA to share "all of the costs" of developing intangibles. Treas. Reg. § 1.482-7(d)(1) (1995). Beginning in 1997, Treasury interpreted stock-based compensation to be such a cost. *See Xilinx, Inc. v. Comm'r*, 598 F.3d 1191, 1193-94 (9th Cir. 2010).

Xilinx, Inc. challenged this interpretation, and the Tax Court ruled in Xilinx's favor. *Xilinx, Inc. v. Comm'r*, 125 T.C. 37, 62 (2005). The Tax Court found as a factual matter that "two unrelated parties in a cost sharing agreement would not share any costs related to [stock-based compensation]." *Xilinx*, 598 F.3d at 1194. At the same time, it found that Treas. Reg. § 1.482-1(b)(1) – i.e., the arm's length standard – still controlled over Treasury's new all costs regulation. *Id*. It therefore found Treasury's reallocation of Xilinx's stock-based compensation costs to be arbitrary and capricious. *Id*.

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[5] Significantly, Congress prompted the creation of the White Paper *at the same time* it added the "commensurate with income" standard to § 482. *See* H.R. Rep. No. 99-841, at 637-38 (1986) (Conf. Rep.), *as reprinted in* 1986 U.S.C.C.A.N. 4075, 4725-26. Specifically, Congress "believe[d] that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect." *Id.* at 638, *as reprinted in* 1986 U.S.C.C.A.N. at 4726. The resulting study – the White Paper – clearly stated that "the commensurate with income standard is fully consistent with the arm's length principle," and that "intangible income must be allocated on the basis of comparable transactions if comparables exist." 1988-2 C.B. at 458, 474.

Our court affirmed the Tax Court, noting that the "purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions," which is determined "based on how parties operating at arm's length would behave." *Id*. at 1196. Because Treasury "d[id] not dispute" that "unrelated parties would not share [stock-based compensation]," we concluded that Treasury could not require related parties to share it. *Id*. at 1194, 1196. We therefore found the all costs provision inoperative.

In his concurrence, Judge Fisher noted that Treasury's defense of the all costs provision relied on a rationale "not clearly articulated . . . until" the commencement of litigation. *Id*. at 1198 (Fisher, J., concurring). Judge Fisher was "troubled by the complex, theoretical nature of many of [Treasury's] arguments . . . . Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them." *Id*.[6]

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[6] Judge Reinhardt dissented, finding instead that the paramount purpose of the regulations is preventing tax avoidance, and noting that tax law is not always fair or reasonable to businesses. *Id*. at 1199-1200 (Reinhardt, J., dissenting). Judge Reinhardt would have resolved the case in favor of Treasury by holding that the specific all costs provision (i.e. specifically addressing QCSAs) takes precedence over the general arm's length standard. *Id*. at 1199.

Judge Reinhardt also sat on the original panel in this case. *See Altera Corp. v. Comm'r*, No. 16-70496, 2018 WL 3542989 (9th Cir. July 24, 2018), *withdrawn*, 898 F.3d 1266 (9th Cir. 2018). There he concurred with the majority, again in favor of Treasury, but on the ground that the meaning of the arm's length standard is so fluid as to permissibly encompass the all costs method. That opinion, published four months after Judge Reinhardt passed away, was ultimately withdrawn. *Yovino v. Rizo*, 139 S. Ct. 706, 707 n.* (2019) (per curiam); *see id*. at 710 ("[F]ederal judges are

C.

In 2003, while the *Xilinx* litigation concerning the 1995 regulation was pending, Treasury published a rule codifying its decision that QCSA parties should share stock-based compensation costs. To achieve this, Treasury updated the arm's length standard provision, Treas. Reg. § 1.482-1, with a cross-reference to its 1995 "all of the costs" provision, *id*. § 1.482-7,[7] and specifically defined "operating expenses" thereunder to include stock-based compensation, *id*. § 1.482-7(d)(2). Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,178 (Aug. 26, 2003). Treasury purported to "believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard," because "unrelated parties entering into QCSAs would generally share stock-based compensation costs." *Id*. at 51,173.

II.

During the 2004-2007 taxable years, Appellee Altera Corporation (Altera) shared certain costs with one of its foreign subsidiaries, Altera International, pursuant to a research and development cost-sharing agreement. Relying on the Tax Court's 2005 decision in *Xilinx*, the companies did not share the costs of stock-based compensation. After Altera filed consolidated income tax returns for these years, Treasury issued notices of deficiency on the grounds that it had

appointed for life, not for eternity."). The majority opinion of the reconstituted panel essentially adopted the reasoning of the original panel.

[7] Subsequent to the 2003 amendments at issue, the Treasury Regulations have been re-organized and Treas. Reg. § 1.482-7 is now § 1.482-7A.

to re-allocate over $100 million in income from Altera International to Altera to account for the unshared costs of stock-based compensation. Treasury asserted that this re-allocation was necessary under Treas. Reg. § 1.482-7(d)(2). Altera timely filed petitions in the Tax Court.

A.

In a unanimous 15-0 decision, the Tax Court agreed with Altera and concluded that the regulation is arbitrary and capricious. *Altera Corp. v. Comm'r,* 145 T.C. 91, 133-34 (2015). The Tax Court determined that, during the rulemaking process, Treasury specifically justified its new stock-based compensation rule on the ground that it "was required by – or was at least consistent with – the arm's-length standard." *Id.* at 121 & n.17 (citing 68 Fed. Reg. at 51,173 ("The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard.")). By contrast, the Tax Court found that Treasury did *not* rely on § 482's "commensurate with income" language, nor could this language sustain an inconsistent rule in any event given Congress's intent for it to work "consistently with the arm's-length standard." *Id.* (citing White Paper at 472, 475).

The Tax Court therefore proceeded to analyze whether Treasury had articulated a reasoned basis for its conclusion that "unrelated parties entering into QCSAs would generally share stock-based compensation costs." *Id.* at 123 (citing 68 Fed. Reg. at 51,173). It found that the administrative record contained no empirical data supporting such a conclusion, that Treasury had made no attempt to search for evidence supporting such a conclusion, and that Treasury was unaware of any actual transaction illustrating such a result. *Id.* at 122-23. To the contrary, the Tax Court noted that Treasury "seemed to accept the commentators' economic analyses, which concluded that . . . unrelated parties to a QCSA would be unwilling to share the exercise spread or grant date value of stock-based compensation." *Id.* at 131. The Tax Court therefore found that "Treasury's 'explanation for its decision . . . runs counter to the evidence before' it." *Id.* (alteration in original) (*quoting Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)). It further concluded that "Treasury's '*ipse dixit* conclusion, coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decisionmaking.'" *Id.* at 134 (quoting *Ill. Pub. Telecomms. Ass'n v. FCC,* 117 F.3d 555, 564 (D.C. Cir. 1997)).

B.

Treasury appealed, and a divided panel of this court reversed. *Altera Corp. v. Commissioner*, 926 F.3d 1061, 1087 (9th Cir. 2019). On appeal, Treasury adopted a new position: that its 2003 rule was justified not because unrelated parties would *actuall*y share costs in the manner the rule now specifies, but because Treasury no longer needs to consider the behavior of unrelated parties at all. Treasury's new theory is that it can allocate costs under a QCSA based on a standard purely internal to the participants, with no analysis of comparable transactions between unrelated entities, and call this an arm's length result. The majority, applying *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), found that this revised interpretation of § 482 is permissible. *Altera*, 926 F.3d at 1075-78. It further concluded that "Treasury's decision to do away with analysis of comparable transactions" was neither arbitrary nor capricious, because it "was made clear enough by citations to legislative history in the notice of proposed rulemaking and in the preamble to the final rule." *Id.* at 1082. Because Treasury abandoned the comparability standard, the majority explained, it was not required to address public comments that emphasized the absence of stock-based compensation cost-sharing in comparable transactions. *Id.*

Judge O'Malley dissented, noting that "Treasury repeatedly recognized that I.R.C. § 482 requires application of an arm's length standard when determining the true taxable income of a controlled taxpayer," and "just as consistently asserted that a comparability analysis is the only way to determine the arm's length standard." *Id.* at 1087 (O'Malley, J., dissenting). She concluded that Treasury could not depart from this well-settled rule using only "a justification Treasury never provided [during the rulemaking process] and one which does not withstand careful scrutiny." *Id.* Judge O'Malley further concluded that the regulation is arbitrary and capricious; that the regulation would be impermissible under *Chevron* even if Treasury had not erred procedurally; and that, because the regulation is invalid, our decision in *Xilinx* controls. *Id.* at 1092-1101.

III.

Under the APA, we must "hold unlawful and set aside agency action" that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). An agency's rule is arbitrary and capricious when it "offer[s] an explanation for its decision that runs counter to the evidence before" it. *State Farm*, 463 U.S. at 43. "The reviewing court should not attempt itself to make up for such deficiencies: 'We may not supply a reasoned basis for the agency's action that the agency itself has not given.'" *Id.* (quoting *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)). As recently emphasized by the Supreme Court, "[w]e cannot ignore [a] disconnect between the decision made and the explanation given. Our review is deferential, but we are 'not required to exhibit a naiveté from which ordinary citizens are free.'" *Dep't of Commerce v. New York,* 139 S. Ct. 2551, 2575 (2019) (quoting *United States v. Stanchich*, 550 F.2d 1294, 1300 (2d Cir. 1977) (Friendly, J.)).

A.

By its own account, Treasury's 2003 rulemaking was an attempted application of the traditional arm's length standard. Reviewing the 2003 rule on this basis, as we must, Treasury acted arbitrarily and capriciously because its "explanation for its decision [ran] counter to the evidence before" it. *State Farm*, 463 U.S. at 43.

Treasury's explanation for its decision during the rulemaking process was that allocating stock-based compensation costs was justified because "unrelated parties entering into QCSAs would generally share stock-based compensation costs." 68 Fed. Reg. at 51,173. Treasury considered this relevant because "[t]he regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles." *Id.* Treasury asserted that "[p]arties dealing at arm's length in [a QCSA] based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation." *Id.* In conclusion, Treasury emphasized that "[t]he final regulations provide that stock-based compensation must be taken into account in the context of QCSAs *because* such a result is consistent with the arm's length standard." *Id.* (emphasis added).

As the unanimous Tax Court rightly concluded, Treasury's stated reasons for concluding that the sharing of stock-based compensation costs was required by the arm's length standard were belied by the evidence. *Altera*, 145 T.C. at 131. Treasury "fail[ed] to cite any evidence supporting its belief that unrelated parties to QCSAs would share stock-based compensation costs," commentators submitted "significant evidence . . . showing that unrelated parties to QCSAs would not share stock-based compensation costs," and Treasury "fail[ed] to respond to much of the submitted evidence." *Id.* As a result, the administrative record contained no empirical data supporting Treasury's conclusion. *Id.* at 122-23. Indeed, Treasury had made no attempt to search for evidence supporting its conclusion, and was unaware of any actual transaction in which unrelated parties had shared stock-based compensation costs. *Id.*

This "disconnect between the decision made and the explanation given" requires that we vacate Treasury's rule as arbitrary and capricious. *Dep't of Commer*ce, 139 S. Ct. at 2575. This should be the end of our analysis.

B.

The panel majority's opinion impermissibly upholds the 2003 rule based on a host of rationales and interpretive maneuvers amounting to "a [purportedly] reasoned basis for the agency's action that the agency itself has not given." *State Farm*, 463 U.S. at 43 (quoting *Chenery*, 332 U.S. at 196).

At no point in Treasury's 2003 rulemaking did it make a finding, let alone one subject to notice and comment, that comparable transactions are per se unavailable for QCSAs, such that other methods must be employed in the first instance. *See Altera,* 926 F.3d at 1077-78, 1083 n.9 (majority opinion) (using legislative history and Treasury's one-sentence rejection of comparables submitted by commenters to draw this conclusion). At no point in Treasury's 2003 rulemaking did it announce that it was returning to a pre-1968 interpretation of § 482 subjecting taxpayers to an unpredictable "fair and reasonable" standard. *See id*. at 1068-69, 1078 (using caselaw from "most of the twentieth century," i.e., before Treasury promulgated more specific regulations in 1968, to justify this return). At no point in Treasury's 2003 rulemaking did it interpret the commensurate-with-income standard to provide an independent justification for its treatment of stock-based compensation. *See id*. at 1077 (using legislative history alone to infer this justification). And at no point in Treasury's 2003 rulemaking did it reverse its longstanding interpretation of the commensurate-with-income standard as consistent with the traditional arm's length standard. *See id*. at 1077, 1081 (deriving a disparate interpretation of the commensurate-with-income standard from whole cloth and relying on Treasury's insertion of a cross-reference to conclude that these newly disparate standards were appropriately "synthesize[d]").

The panel majority ignores Treasury's clear statements in the preamble to its 2003 rule expressly justifying its treatment of stock-based compensation based on a traditional arm's length analysis employing (unsubstantiated) comparable transactions. *See* 68 Fed. Reg. at 51,173. The panel upholds the rule only by accepting Treasury's convenient litigating position on appeal that it permissibly jettisoned the traditional arm's length standard altogether. *See Altera*, 926 F.3d at 1077. By re-writing the reasoning supporting the rule, the majority renders extensive comments irrelevant, and is strangely untroubled by the idea that no member of the tax community noticed this alternative reasoning or submitted a relevant comment. *See id.* at 1081-82; *cf. Chisom v. Roemer*, 501 U.S. 380, 396 n.23 (1991) ("I think judges as well as detectives may take into consideration the fact that a watchdog did not bark in the night.") (quoting *Harrison v. PPG Industries, Inc.,* 446 U.S. 578, 602 (1980) (Rehnquist, J., dissenting)).

The APA does not allow an agency to reclassify the reasoning it articulated to the public as "extraneous observations," Appellant's Br. at 64, ignore public comments pointing out the failures in such reasoning, and then defend its rule in litigation using reasoning the public never had notice of. Yet that is precisely what the majority's opinion allows Treasury to do.

C.

Even if an agency could force the public to engage in a "scavenger hunt" for "cryptic" references in order to understand its reasoning in the ordinary rulemaking case, *Altera*, 926 F.3d at 1087-88 (O'Malley, J., dissenting), the APA would prohibit Treasury from doing so here:

> When an agency changes its existing position, it "need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate." But the agency must at least "display awareness that it is changing position" and "show that there are good reasons for the new policy." In explaining its changed position, an

> agency must also be cognizant that longstanding policies may have "engendered serious reliance interests that must be taken into account."

Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2125-26 (2016) (citations omitted) (quoting *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009)).

In contrast to its statements during the 2003 rulemaking and before the Tax Court, Treasury no longer disputes that stock-based compensation costs cannot be re-allocated under the traditional arm's length standard. A legitimate rule requiring the sharing of stock-based compensation costs would therefore have necessitated a *change in position* regarding the type of standard permissibly employed under § 482. The relevant Supreme Court precedents call us to be particularly vigilant in ensuring that Treasury provided fair notice of this change in position. *See id*. It did not.

The majority opinion assumes away this problem by relying on legislative history from the 1986 amendment, making it seem as though the necessary interpretation of § 482 had been on the books for nearly twenty years before the 2003 rule. *See Altera*, 926 F.3d at 1085-86 (majority opinion). But Treasury expressly disclaimed the majority's interpretation of the 1986 amendment in the 1988 White Paper. White Paper at 472. The interpretation of § 482 on the books in 2003 was the traditional arm's length standard. Therefore, even if Treasury had articulated a permissible reinterpretation of § 482 in its 2003 rule, its failure to acknowledge the newness of this interpretation, let alone to consider the "serious reliance interests" engendered by the previous interpretation, would supply an independent reason to vacate the rule. *Encino*

Motorcars, 136 S. Ct. at 2126 (quoting *Fox*, 556 U.S. at 515).

IV.

The majority opinion additionally errs by accepting the interpretation of § 482's commensurate-with-income provision that Treasury now advocates. Treasury's interpretation is not entitled to deference, and it conflicts with the plain language of the statute.

A.

"[A] court must make an independent inquiry into whether the character and context of the agency interpretation entitles it to controlling weight." *Kisor v. Wilkie*, 139 S. Ct. 2400, 2416 (2019) (citing *United States v. Mead Corp.*, 533 U.S. 218, 229-31, 236-37 (2001)). For example, "*Chevron* deference is not warranted where the regulation is 'procedurally defective' – that is, where the agency errs by failing to follow the correct procedures in issuing the regulation." *Encino Motorcars*, 136 S. Ct. at 2125. As demonstrated above, Treasury's 2003 rule was procedurally defective because its "explanation for its decision [ran] counter to the evidence before" it. *State Farm*, 463 U.S. at 43. Even had it articulated a reasoned basis for its rule, it failed to "display awareness that it [was] changing position." *Fox*, 556 U.S. at 515. "An arbitrary and capricious regulation of this sort is itself unlawful and receives no *Chevron* deference." *Encino Motorcars*, 136 S. Ct. at 2126.

Moreover, Treasury did *not* articulate a reasoned basis for its rule during notice-and-comment rulemaking, but rather attempts to do so now in its briefing on appeal. "Deference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988); *cf.*

Kisor, 139 S. Ct. at 2417-18 ("[A] court should decline to defer to a merely 'convenient litigating position' or '*post hoc* rationalizatio[n] advanced' to 'defend past agency action against attack.' And a court may not defer to a new interpretation, whether or not introduced in litigation, that creates 'unfair surprise' to regulated parties. That disruption of expectations may occur when an agency substitutes one view of a rule for another." (citations and footnote omitted) (first quoting *Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142, 155 (2012), then quoting *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 170 (2007))). A litigating position is not "promulgated in the exercise of [Congressionally delegated] authority," *Mead*, 533 U.S. at 227, because it is not adopted "through any 'relatively formal administrative procedure,'" *Price v. Stevedoring Servs. of Am., Inc.*, 697 F.3d 820, 827 (9th Cir. 2012) (en banc) (quoting *Mead*, 533 U.S. at 230). Rather, an agency's litigating position can "ordinarily [be] change[d] . . . from one case to another" via "internal decisionmaking not open to public comment or determination." *Id*. at 827, 830; *cf. Xilinx*, 598 F.3d at 1198 (Fisher, J., concurring) ("Not only do[]" Treasury's "complex, theoretical" litigating arguments "make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them."). Nor is there any indication that Treasury's litigating position here "is one of long standing" or the product of "careful consideration . . . over a long period of time," *Barnhart v. Walton*, 535 U.S. 212, 221-22 (2002), seeing as how Treasury did not even make the same argument to the Tax Court in this matter.

Though some amici suggest it could, Treasury does not ask for *Auer* deference to its interpretation of

Treas. Reg. § 1.482-1 (the arm's length standard). *See Auer v. Robbins,* 519 U.S. 452 (1997). Given the very detailed limitations on *Auer* deference spelled out in *Kisor*, virtually none of which Treasury's actions satisfy, it is clear that such deference would not be available even if not disclaimed. *See* 139 S. Ct. at 2415-18 (*e.g.,* generally does not apply to "an agency construction 'conflict[ing] with a prior' one," *id*. at 2418 (quoting *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 515 (1994))).

Even *Skidmore* deference is likely inappropriate here, where "billions of dollars" are at stake. *King v. Burwell*, 135 S. Ct. 2480, 2488-89 (2015) (finding *Chevron* inapplicable and making no mention of *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)).

B.

Setting aside whether Treasury's new interpretation of the commensurate-with-income standard obeys Treasury's own determination that Congress intended it to work "consistently with the arm's length standard," White Paper at 472, 475, the commensurate-with-income provision simply does not apply to QCSAs.

By its terms, the provision is applicable only if QCSAs constitute "transfers of intangible property." I.R.C. § 482. They do not. The majority opinion focuses on the breadth of the word "transfers," modified by "any," to conclude that transfers of future distribution rights fall within the provision's ambit. *Altera*, 926 F.3d at 1076. This reasoning suffers from two defects. First, QCSAs do not involve a transfer of future distribution rights. Treasury itself characterized QCSAs as "cost sharing arrangements *for the development* of high-profit intangibles." 68 Fed. Reg. at 51,173 (emphasis added). "No rights are transferred when parties enter into an agreement to *develop* intangibles; this is because the rights to later-developed intangible property would spring *ab initio* to the parties who shared the development costs without any need to transfer the property." *Altera*, 926 F.3d at 1098 (O'Malley, J. dissenting). Second, the statutory definition of "intangible property" comprises a list of property types that *currently* exist, none of which resembles *future* distribution rights. *See supra*, note 4; I.R.C. § 936(h)(3)(B) (1996).[8]

The panel majority's application of the commensurate-with-income standard to Altera's QCSA was therefore incorrect. Even "under *Chevron*, the agency's reading must fall 'within the bounds of reasonable interpretation.' And let there be no mistake: That is a requirement an agency can fail." *Kisor*, 139 S. Ct. at 2416 (citation omitted) (quoting *Arlington v. FCC*, 569 U.S. 290, 296 (2013)).

V.

In addition to being wrongly decided, the panel majority's decision engenders particularly deleterious practical consequences.

First, the majority opinion will likely upset the uniform application of the challenged regulation in the Tax Court, producing a situation akin to a circuit

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[8] The majority's discussion of future commodities, *Altera*, 926 F.3d at 1076 (majority opinion), is particularly off the mark given that such futures are excluded from the definition of intangible property as having value "attributable to tangible property." I.R.C. § 367(d)(4)(G). The majority's assertion that *stock-based compensation* is a transferred intangible under a QCSA only further confuses the point. *See id.* Treasury is attempting to reallocate Altera's income in this case precisely because the parties did *not* transfer any stock-based compensation costs.

split. Although the Tax Court "will follow the clearly established position of a Court of Appeals to which a case is appealable," it "will give effect to [its] own views in cases appealable to courts that have not yet decided the issue." *Mitchell v. Comm'r*, 106 T.C.M. (CCH) 215, 220 n.7 (2013); *cf. Fehlhaber v. Comm'r*, 94 T.C. 863, 867 (1990) (disagreeing with a reversal by the Ninth Circuit and adhering to its position in cases outside the Ninth Circuit). The Tax Court determined unanimously, in a 15-0 decision, that Treasury's 2003 rulemaking "epitomize[d] arbitrary and capricious decisionmaking.'" 145 T.C. at 134 (quoting *Ill. Pub. Telecomms. Ass'n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1997)). This uncommon unanimity and severity of censure strongly suggest that the Tax Court will continue to be persuaded by its original reasoning. If so, the tax treatment of stock-based compensation costs will turn on the happenstance of where a business is located and create incentives to locate or incorporate elsewhere. Such a possibility is particularly problematic in the context of federal taxation, given that "[a] cardinal principle of Congress in its tax scheme is uniformity." *United States v. Gilbert Assocs., Inc.*, 345 U.S. 361, 364 (1953). In the meantime, businesses lack certainty regarding the meaning of the arm's length standard outside the Ninth Circuit.

Second, the panel majority's opinion tramples on the longstanding reliance interests of American businesses. *See* Appellee's Petition for Rehearing En Banc at 1-2, App'x C 1-4 (listing 56 companies that "noted the *Altera* issue in their annual reports (Forms 10-K) to the SEC," ranging from Alphabet Inc., reporting $4.4 billion at stake, to Groupon, Inc., reporting $14 million at stake). "Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences." *Comm'r v. Greenspun*, 670 F.2d 123, 126 (9th Cir. 1982) (quoting *United States v. Byrum*, 408 U.S. 125, 135 (1972)).

Finally, as numerous amici observe, the panel majority opinion upsets not only domestic tax law, but international tax law as well. The allocation of income between related entities operating in different countries is a problem that must be addressed not only by Treasury and the IRS, but also by the relevant foreign tax agencies. In order to avoid double taxation, and pursuant to tax treaties negotiated by the United States, the arm's length method is "used by all major developed nations." *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 305 (1994). The panel majority's interpretation of § 482 as allowing for the use of a *purely internal* standard to make cost and income allocations, i.e., without ever inquiring as to the behavior of parties *operating at arm's length*, greatly upsets this international uniformity.

* * *

Treasury justified its 2003 rule as an application of the traditional arm's length standard. Without searching for any evidence, it assumed it knew what comparable transactions would look like. Without any real analysis, it dismissed comments providing contrary examples. The en banc Tax Court unanimously, and rightly, invalidated the rule as arbitrary and capricious because Treasury's explanation for its decision ran counter to the evidence before it. Only before this court did Treasury conjure a new justification for the rule, not only newly applying the commensurate-with-income provision of the statute, but also newly interpreting that provision to bypass the traditional arm's length standard.

The panel majority was wrong to accept this justification, both procedurally and substantively. Its decision invites an effective circuit split, ignores the reasonable reliance of businesses on the well-settled arm's length standard, subjects those businesses to double taxation, and sows uncertainty over the fate of billions of dollars. Moreover, its endorsement of Treasury's arbitrary and capricious rulemaking sends a signal that executive agencies can bypass proper notice-and-comment procedures as long as they come up with a clever post-hoc rationalization by the time their rules are litigated.

I respectfully dissent from the denial of rehearing en banc.

APPENDIX D

1. 5 U.S.C. 553 provides:

(a) This section applies, according to the provisions thereof, except to the extent that there is involved –

(1) a military or foreign affairs function of the United States; or

(2) a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts.

(b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include –

(1) a statement of the time, place, and nature of public rule making proceedings;

(2) reference to the legal authority under which the rule is proposed; and

(3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.

Except when notice or hearing is required by statute, this subsection does not apply—

(A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or

(B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this subsection.

(d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except –

(1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

(2) interpretative rules and statements of policy; or

(3) as otherwise provided by the agency for good cause found and published with the rule.

(e) Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.

2. 5 U.S.C. 706 provides:

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall –

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be –

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

3. 26 U.S.C. 482 provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

4. 26 C.F.R. 1.482-1 provides, in pertinent part:

(a) *In general* –

(1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482. Section 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, includ-

ing controlled transactions involving loans or advances or the use of tangible property. Sections 1.482-3 through 1.482-6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after January 5, 2009. Section 1.482-8 provides examples illustrating the application of the best method rule. Finally, § 1.482-9 provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.

(2) *Authority to make allocations*. The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

(3) *Taxpayer's use of section 482*. If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease

taxable income based on allocations or other adjustments with respect to controlled transactions. See § 1.6662-6T(a)(2) or successor regulations.

(b) *Arm's length standard* –

(1) *In general*. 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. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See § 1.482-1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482-1(c).

(2) *Arm's length methods* –

(i) *Methods*. Sections 1.482-2 through 1.482-7 and 1.482-9 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result. This section provides general principles applicable in determining arm's length results of such controlled transactions, but do not provide methods, for which reference must be made to those other sections in accordance with paragraphs (b)(2)(ii) and (iii) of this section. Section 1.482-7 provides the specific methods to be used to evaluate whether a cost sharing arrangement as defined in § 1.482-7 produces results consistent with an arm's length result.

(ii) *Selection of category of method applicable to transaction.* The methods listed in § 1.482-2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result. But see § 1.482-1(f)(2)(i) (Aggregation of transactions). In addition, other applicable provisions of the Code may affect the characterization of a transaction, and therefore affect the methods applicable under section 482. See for example section 467.

(iii) *Coordination of methods applicable to certain intangible development arrangements.* Section 1.482-7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement as defined in § 1.482-7. Sections 1.482-4 and 1.482-9, as appropriate, provide the specific methods to be used to determine arm's length results of arrangements, including partnerships, for sharing the costs and risks of developing intangibles, other than a cost sharing arrangement covered by § 1.482-7. See also §§ 1.482-4(g) (Coordination with rules governing cost sharing arrangements) and 1.482-9(m)(3) (Coordination with rules governing cost sharing arrangements).

(c) *Best method rule* –

(1) *In general*. The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See § 1.482-8 for examples of the application of the best method rule. See § 1.482-7 for the applicable methods in the case of a cost sharing arrangement.

(2) *Determining the best method*. Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction

are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. These factors are explained in paragraphs (c)(2)(i), (ii), and (iii) of this section.

(i) *Comparability*. The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in § 1.482-1(d)(3) (Factors for determining comparability), and after making adjustments for differences, as described in § 1.482-1(d)(2) (Standard of comparability). As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. See § 1.482-3(b)(2)(ii)(A). An analysis will be relatively less reliable, however, as the un controlled transactions become less comparable to the controlled transaction.

(ii) *Data and assumptions*. Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. These factors are discussed in paragraphs (c)(2)(ii) (A), (B), and (C) of this section.

(A) *Completeness and accuracy of data*. The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(B) *Reliability of assumptions*. All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgement, the economic analysis on which the assumption is based is relatively sound. Other assumptions may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method.

(C) *Sensitivity of results to deficiencies in data and assumptions*. Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(iii) *Confirmation of results by another method*. If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

* * * * *

5. 26 C.F.R. 1.482-7 (2003) provides, in pertinent part:

(d) *Costs* –

(1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in § 1.482-5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482-5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. If tangible property is made available to the qualified cost sharing arrangement by a controlled participant, the determination of the appropriate charge will be governed by the rules of § 1.482-2(c) (Use of tangible property). Intangible development costs do not include the consideration for the use of any intangible property made available to the qualified cost sharing arrangement. See paragraph (g)(2) of this section. If a particular

cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

(2) *Stock-based compensation* –

(i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development.* The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense* –

(A) *In general*. Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for Federal income tax purposes with respect to that stock- based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies*. Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option.* Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(*4*) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock* –

(*1*) *In general*. With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock*. As used in this paragraph (d)(2)(iii)(B), the term publicly traded stock means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles*. For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either –

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election.* The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) *Consistency*. Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

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6. 26 C.F.R. 1.482-7 provides, in pertinent part:

(d) *Intangible development costs* –

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(3) *Stock-based compensation* –

(i) *In general*. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation with the IDA*. The determination of whether stock-based compensation is directly identified with, or reasonably allocable to, the IDA is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the CSA and, at date of grant, is directly identified with, or reasonably allocable to, the IDA is included as an IDC under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(3)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation IDC* –

(A) *In general*. Except as otherwise provided in this paragraph (d)(3)(iii), the cost attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an IDC under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies*. Solely for purposes of this paragraph (d)(3)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants*. Solely for purposes of this paragraph (d)(3)(iii)(A), an amount is treated as an allowable deduction of a foreign controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option*. Solely for purposes of this paragraph (d)(3)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(3)(ii) of this section, to constitute the grant of a new stock option not identified with, or reasonably allocable to, the IDA, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(3)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an IDC as of the date of the modification.

(*4*) *Expiration or termination of CSA*. Solely for purposes of this paragraph (d)(3)(iii)(A), if an item of stock-based compensation identified with, or reasonably allocable to, the IDA is not exercised during the term of a CSA, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the CSA, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(3)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an IDC as of the date of the expiration or termination of the CSA.

(B) *Election with respect to options on publicly traded stock* –

(*1*) *In general*. With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a CSA may elect to take into account all IDCs attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock*. As used in this paragraph (d)(3)(iii)(B), the term publicly traded stock means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles.* For purposes of this paragraph (d)(3)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either –

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election*. The election described in this paragraph (d)(3)(iii)(B) is made by an explicit reference to the election in the written contract required by paragraph (k)(1) of this section or in a written amendment to the CSA entered into with the consent of the Commissioner pursuant to paragraph (d)(3)(iii)(C) of this section. In the case of a CSA in existence on August 26, 2003, the election by written amendment to the CSA may be made without the consent of the Commissioner if such amendment is entered into not later than the latest due date (with regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003.

(C) *Consistency*. Generally, all controlled participants in a CSA taking options on publicly traded stock into account under paragraph (d)(3)(ii), (d)(3)(iii)(A), or (d)(3)(iii)(B) of this section must use that same method of identification, measurement and timing for all options on publicly traded stock with respect to that CSA. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the CSA must join in requests for the Commissioner's consent under this paragraph (d)(3)(iii)(C). Thus, for example, if the controlled participants make the election described in paragraph (d)(3)(iii)(B) of this section upon the formation of the CSA, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(3)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(3)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(3)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

* * * * *

APPENDIX E

Federal Register / Vol. 67, No. 145 / Monday, July 29, 2002 / Proposed Rules **48997**

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106359-02]

RIN 1545-BA57

Compensatory Stock Options Under Section 482

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding the application of the rules of section 482 governing qualified cost sharing arrangements. These proposed regulations provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements and for purposes of the comparability factors to be considered under the comparable profits method. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 28, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 20, 2002, must be received by October 30, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-106359-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG-106359-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *http://www.irs.gov/regs*. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Douglas Giblen, (202) 874-1490; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by September 27, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information requirements are in proposed §§ 1.482-7(d)(2)(iii)(B) and 1.482-7(j)(2)(i)(F). This information is required by the IRS to monitor compliance with the federal tax rules for determining stock-based compensation costs related to intangible development to be shared among controlled participants in qualified cost sharing arrangements. The likely respondents are taxpayers who enter into these arrangements. Responses to this collection of information are required to determine these taxpayers' proper shares of stock-based compensation costs incurred with respect to these arrangements.

Section 1.482-7(d)(2)(iii)(B) of the proposed regulations provides that controlled participants may elect an alternative method of measurement of certain stock-based compensation by clearly referring to the election in the written cost sharing agreement required under existing regulations or by amending a cost sharing agreement already in effect to refer to the election. Section 1.482-7(j)(2)(i)(F) requires controlled participants to maintain documentation necessary to establish the amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used in computing that amount, and the data, as of the date of grant, used to identify stock-based compensation related to the development of intangibles.

Estimated total annual reporting and/or recordkeeping burden: 2,000 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: The estimated annual burden per respondent varies from 2 hours to 7 hours, depending on individual circumstances, with an estimated average of 4 hours.

Estimated number of respondents and/or recordkeepers: 500.

Estimated frequency of responses: Annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 482 of the Internal Revenue Code generally provides that the Secretary may allocate gross income, deductions and credits between or among two or more taxpayers owned or controlled by the same interests in order to prevent evasion of taxes or clearly to reflect income. On July 8, 1994, Treasury and the IRS published in the **Federal Register** (59 FR 34988) final regulations (T.D. 8552, 1994-2 C.B. 93) under section 482 in areas other than cost sharing. On December 20, 1995, Treasury and the IRS published in the **Federal Register** (60 FR 65553) final cost sharing regulations (T.D. 8632, 1996-1 C.B. 85), effective for taxable years beginning on or after January 1, 1996. Amendments to T.D. 8632 were published in the **Federal Register** on May 13, 1996, at 61 FR 21955 (T.D. 8670, 1996-1 C.B. 99), and on January 3, 2001, at 66 FR 280 (T.D. 8930, 2001-1 I.R.B. 433).

The 1994 final regulations under section 482 contain general provisions at § 1.482-1 describing the arm's length standard and the best method rule. The final cost sharing regulations at § 1.482-7 generally require that controlled participants in a qualified cost sharing arrangement share intangible development costs in proportion to their shares of the reasonably anticipated benefits attributable to the development of the intangibles covered by the arrangement. These proposed regulations clarify that stock-based compensation is taken into account in determining the operating expenses treated as a controlled participant's intangible development costs for purposes of the cost sharing provisions; provide rules for measuring the cost associated with stock-based compensation; clarify that the utilization and treatment of stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method under § 1.482-5; and clarify the coordination of the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1.

Explanation of Provisions

Overview

The Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 2561 *et seq*. (reprinted at 1986-3 C.B. (Vol. 1) 1, 478) (the Act), amended section 482 to require that consideration for intangible property transferred in a controlled transaction be commensurate with the income attributable to the intangible. The legislative history of the Act indicated that in adding this commensurate with income standard to section 482, Congress did not intend to preclude the use of bona fide research and development cost sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, "if and to the extent such agreements are consistent with the purpose of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs * * * ." H.R. Rep. No. 99-841, at II-638 (1986) (the Conference Report).

The Conference Report recommended that the IRS conduct a comprehensive study and consider whether the regulations under section 482 (issued in 1968) should be modified in any respect. In response to this directive, on October 18, 1988, Treasury and the IRS issued a study of intercompany pricing (the White Paper), published as Notice 88-123, 1988-2 C.B. 458. With respect to cost sharing arrangements, the White Paper observed that Congress intended such arrangements to produce results consistent with the purposes of the commensurate with income standard in section 482, and in particular that allocations of income among the participants reasonably reflect the participants' respective economic activity. 1988-2 C.B. at

459, 495. The White Paper further observed that Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm's length standard. 1988-2 C.B. at 458, 477.

Section 1.482-1 of the 1994 final regulations provides that a controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. A method selected under the best method rule is used to determine whether a controlled transaction produces an arm's length result. The regulations reference §§ 1.482-2 through 1.482-6 as providing specific methods to be used in this determination.

Section 1.482-7 of the 1995 final regulations implements the commensurate with income standard in the context of cost sharing arrangements. The final cost sharing regulations require that controlled participants in a qualified cost sharing arrangement share all costs incurred that are related to the development of intangibles in proportion to their shares of the reasonably anticipated benefits attributable to that development. Section 1.482-7(d)(1) defines these intangible development costs as including operating expenses as defined in § 1.482-5(d)(3), other than depreciation or amortization, plus an arm's length rental charge determined under § 1.482-2(c) for the use of any tangible property made available to the qualified cost sharing arrangement. Section 1.482-5(d)(3) defines operating expenses, for purposes of the comparable profits method under section 482, as including all expenses not included in cost of goods sold except for interest expense, foreign and domestic income taxes, and any other expenses not related to the operation of the relevant business activity. In the context of cost sharing, the relevant business activity is the development of intangibles covered by the cost sharing arrangement.

Since the promulgation of the final cost sharing regulations in 1995, the issue has been raised whether operating expenses within the meaning of § 1.482-7(d)(1) include compensation provided by a controlled participant in the form of stock options. Related questions have been posed in this context regarding the interaction between the arm's length standard and the cost sharing regulations.

These proposed regulations amend the final regulations to clarify that stock-based compensation must be taken into account in determining operating expenses under § 1.482-7(d)(1) and to provide rules for measuring stock-based compensation costs. These proposed regulations also clarify that stock-based compensation should be taken into account in comparability determinations pursuant to the comparable profits method under § 1.482-5. Finally, the proposed regulations amend the final regulations to include express provisions to coordinate the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1.

Inclusion of Stock-Based Compensation in Intangible Development Costs

The proposed regulations provide that in determining a controlled participant's operating expenses within the meaning of § 1.482-7(d)(1), all compensation, including stock-based compensation, must be taken into account. The proposed regulations also provide rules for measuring the operating expenses attributable to stock-based compensation.

The definition of stock-based compensation for purposes of these proposed regulations is broad, comprising any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, stock options, or rights in (or determined by reference to) such instruments or options, regardless of whether the compensation ultimately is settled in the form of cash, stock, or other property. Thus, these proposed regulations are intended to reach such forms of compensation as restricted stock, nonstatutory stock options, statutory stock options (incentive stock options described in section 422(b) and options granted under an employee stock purchase plan described in section 423(b)), stock appreciation rights, and phantom stock. Statutory stock options are within the scope of the definition regardless of whether the employer is entitled to an income tax deduction with respect to those options.

The proposed regulations provide that the determination of whether stock-based compensation is related to the development of intangibles covered by the qualified cost sharing arrangement is to be made as of the date the stock-based compensation is granted. For example, controlled participants must share the costs attributable to stock-based compensation that is granted to an employee who, at the time of grant, is performing research services related to the qualified cost sharing arrangement. Treasury and the IRS believe that this rule appropriately identifies the stock-based compensation to be shared because the grant of compensation generally is the economic event most closely associated in time with the services being compensated. Because a controlled participant may choose whether to provide stock-based or cash compensation, this rule also promotes neutrality of treatment as among various forms of compensation. Finally, because the grant-date identification rule applies irrespective of the method used by the controlled participant to measure or determine the timing of inclusion of stock-based compensation in the intangible development costs to be shared, the rule ensures that the same items of stock-based compensation will be taken into account under any method, thus promoting neutrality in the choice of measurement method afforded by the proposed regulations.

In applying the grant-date identification rule in cases where a stock option is repriced or otherwise modified, the rules of section 424(h) and related regulations will be used to determine whether the grant of a new stock option has occurred.

Treasury and the IRS recognize that tax and other accounting principles permit the cost associated with stock-based compensation to be measured and taken into account as of different points in time and under various methodologies for different purposes. For example, for general income tax purposes, the amount of compensation taxed to an employee and deductible by an employer upon exercise of a stock option not governed by sections 421-424 (commonly referred to as a nonstatutory stock option) generally is measured by the "spread" between the option price and the fair market value of the underlying stock at the date of exercise. *See* §§ 83(a), 83(h), 1.83-1(a)(1), 1.83-6(a)(1).

For various other tax purposes, however, the IRS has adopted modified versions of economic pricing models, such as the Black-Scholes model, for valuing stock options at specific points in time prior to exercise. See Rev. Proc. 98-34, 1998-1 C.B. 983 (estate and gift tax valuation); Rev. Proc. 2002-13, 2002-8 I.R.B. 549, as modified by Rev. Proc. 2002-45, 2002-27 I.R.B.

40 (measurement of stock-option-based golden parachute payments under sections 280G and 4999). Pricing models also have been adopted in the context of financial accounting. The Financial Accounting Standards Board (FASB) refers to pricing models for measurement of the stock-based compensation expense that a company is required to report at "fair value," either as a charge to income or, at the company's option, in a pro forma footnote disclosure. *See* FASB Statement 123, Accounting for Stock-Based Compensation (October 1995).

Generally accepted pricing models can be applied at the date of grant to estimate the economic cost of a stock option to the issuer. General support for the use of economic measures of cost in the transfer pricing context may be found in the legislative history of the commensurate with income standard and in the White Paper, which state that to be consistent with the commensurate with income standard, cost sharing arrangements must "reflect the actual economic activity" of participants. Conference Report at II-638 and White Paper at 1988-2 C.B. 495.

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. Treasury and the IRS also recognize the importance of providing rules that are administrable.

The proposed regulations prescribe a general rule of measurement based primarily on the amount and timing of the income tax deduction associated with stock-based compensation, while in certain cases permitting controlled participants in a qualified cost sharing arrangement to elect a rule of measurement with respect to stock options based on the amount and timing of the fair value of the option that is required to be computed for purposes of financial accounting in accordance with United States generally accepted accounting principles (U.S. GAAP).

To provide for uniform measurement of the cost associated with both statutory and nonstatutory stock options, the general deduction-based measurement rule is applied as if section 421 did not apply upon the exercise of a statutory stock option. Thus, although section 421 generally disallows compensation deductions with respect to the exercise of statutory stock options except in the case of certain disqualifying dispositions, the proposed regulations treat the exercise of a statutory stock option as giving rise to a deduction for purposes of the deduction-based measurement rule. Consequently, the operating expense with respect to all stock options, whether statutory or nonstatutory, generally will be measured by the "spread" and taken into account as of the date the stock option is exercised.

To place a foreign controlled participant on an equal footing with a United States controlled participant, an amount is treated as deductible by a foreign controlled participant, solely for purposes of the general deduction-based measurement rule, as if the amount were paid or incurred by a United States taxpayer, even if the foreign controlled participant is not subject to United States taxing jurisdiction and so would not otherwise be entitled to a deduction under United States income tax law.

Solely for purposes of the general deduction-based measurement rule, any item of stock-based compensation that is eligible to be exercised and that remains outstanding on the expiration or termination of a qualified cost sharing arrangement will be treated as being exercised immediately before the expiration or termination, provided that the fair market value of the underlying stock at that time exceeds the price at which the stock-based compensation is exercisable. The result of this treatment is that the excess of the fair market value of the underlying stock over the price at which the stock-based compensation is exercisable is taken into account as an operating expense for the taxable year in which the qualified cost sharing arrangement expires or terminates. This special rule would apply, for example, in the case of a currently exercisable statutory stock option or a substantially vested nonstatutory stock option where the fair market value of the underlying stock exceeds the option price at the time the qualified cost sharing arrangement is terminated. The rule ensures that controlled participants take into account for cost sharing purposes all stock-based compensation that is attributable to the development of intangibles and has become exercisable during the term of the cost sharing arrangement. In cases where significant amounts of stock-based compensation have been granted, but are not exercisable at the time of the termination of the arrangement, the IRS anticipates that factual issues regarding the termination of the qualified cost sharing arrangement will arise if the arrangement is reinstated.

A similar rule applies if, during the term of the qualified cost sharing arrangement, a newly granted stock option is determined to result from a repricing or other modification of another stock option and is not related to the development of intangibles at the time of the modification. In this situation, an amount is taken into account for purposes of the general deduction-based measurement rule as if the original stock option had been exercised immediately before the modification.

The proposed regulations permit an elective method of measurement and timing with respect to options on publicly traded stock of companies subject to financial reporting under U.S. GAAP, provided that the stock is traded on a United States securities market.

Under the election, the amount of the operating expense associated with compensatory stock options is their "fair value," generally measured by reference to economic pricing models as of the date of grant, as reflected either as a charge against income or as a footnote disclosure in the company's audited financial statements, in compliance with current U.S. GAAP. Where the election is made with respect to stock in a company that does not take stock-based compensation expense as a charge against income for financial accounting purposes but rather chooses, as permitted by current U.S. GAAP (for example, FASB Statement 123), to disclose such compensation in a footnote to the financial statements, stock-based compensation is taken into account in the same amount, and as of the same time, as the pro forma fair value figures reflected in the footnote.

The election to measure the operating expense associated with compensatory stock options in accordance with financial accounting rules must be clearly referenced in the written cost sharing agreement required under § 1.482-7(b)(4) and must bind all controlled participants. A transition rule permits controlled participants to amend pre-existing cost sharing agreements not later than the latest due date (without regard to extensions) for an income tax return of a controlled participant for the first taxable year beginning after the effective date of final regulations incorporating this rule.

The proposed regulations contain consistency rules to ensure that all controlled participants in a qualified cost sharing arrangement normally will use the same method of measurement for all options on publicly traded stock with respect to that arrangement. Once a method of measurement has been adopted with respect to stock options granted in a taxable year following the effective date of the proposed regulations, the method of measurement may not be changed for those stock options. With respect to subsequently granted stock options to which the transition rule does not apply, the proposed regulations provide that a method of measurement different from that adopted following the effective date of the proposed regulations may be adopted only with the consent of the Commissioner.

To ensure that taxpayers maintain documentation supporting all amounts taken into account as operating expenses attributable to stock-based compensation, these proposed regulations add to the documentation requirements of § 1.482-7(j)(2)(i) an item specifically relating to stock-based compensation.

Treatment of Stock-Based Compensation Under Other Provisions

The treatment of stock-based compensation as a cost or operating expense for purposes of the transfer pricing of services and for purposes of applying the comparable profits method will be considered by Treasury and the IRS in a separate regulation project. Accordingly, these regulations do not propose amendments to the definitions of cost or operating expense in § 1.482-2(b) or § 1.482-5(d)(3). However, these proposed regulations amend § 1.482-5(c)(2)(iv) to clarify that in applying the comparable profits method, material differences among the tested party and uncontrolled comparables with respect to the utilization or treatment of stock-based compensation are an appropriate basis for comparability adjustments.

Coordination of Cost Sharing With the Arm's Length Standard

These proposed regulations add express provisions coordinating the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1. New § 1.482-7(a)(3) clarifies that in order for a qualified cost sharing arrangement to produce results consistent with an arm's length result within the meaning of § 1.482-1(b)(1), all requirements of § 1.482-7 must be met, including the requirement that each controlled participant's share of intangible development costs equal its share of reasonably anticipated benefits attributable to the development of intangibles. The proposed regulations also make amendments to § 1.482-1 to clarify that § 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result, and to clarify that under the best method rule, the provisions of § 1.482-7 set forth the applicable method with respect to qualified cost sharing arrangements.

Through these new provisions, Treasury and the IRS intend to clarify that all of the specific rules necessary to the determination of costs, reasonably anticipated benefits and other aspects of qualified cost sharing arrangements are either contained or cross-referenced within § 1.482-7. Thus, for example, regarding buy-in payments with respect to pre-existing intangibles made available to qualified cost sharing arrangements, §§ 1.482-7(a)(2) and 1.482-7(g) cross-reference various other sections of the regulations under section 482. For the determination of reasonably anticipated benefits, § 1.482-7(f)(3) expressly requires that certain comparability factors described in § 1.482-1(c)(2)(ii) under the best method rule be considered. With respect to identification of the costs to be shared, the rules are contained within § 1.482-7(d)(1), which refers to "all" intangible development costs and cross-references the definition of operating expenses in § 1.482-5(d)(3) and the provisions of § 1.482-2(c) governing determination of arm's length rental charges for tangible property. The § 1.482-7(d)(1) definition of intangible development costs is supplemented by the provisions of § 1.482-7(c)(2), which cross-references the provisions of § 1.482-4(f)(3)(iii) to determine arm's length consideration for research assistance performed by a controlled taxpayer that is not a controlled participant.

Proposed Effective Date

These regulations are proposed to apply to stock-based compensation granted in taxable years beginning on or after the date these regulations are published as a Treasury Decision promulgating final regulations in the **Federal Register**. Notwithstanding this prospective effective date, Treasury and the IRS intend that taxpayers may rely on these proposed regulations until the effective date of the final regulations. No inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of the final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to enter into qualified cost sharing arrangements involving stock-based compensation, and that for those who do, the burdens imposed under §§ 1.482-7(d)(2)(iii)(B) and 1.482-7(j)(2)(i)(F) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. Treasury and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 21, 2002, at 10 a.m., in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 30, 2002. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Douglas Giblen of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1 – INCOME TAXES

1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Sections 1.482-1, 1.482-5 and 1.482-7 also issued under 26 U.S.C. 482. * * *

Section 1.482-0 is amended by:

1. Redesignating the entry for § 1.482-7(a)(3) as the caption for § 1.482-7(a)(4).

2. Adding a new entry for § 1.482-7(a)(3).

3. Redesignating the entry for § 1.482-7(d)(2) as the caption for § 1.482-7(d)(3).

4. Adding new entries for § 1.482-7(d)(2).

The additions and revisions read as follows:

§ 1.482-0 Outline of regulations under section 482.

* * * * *

§ 1.482-7 Sharing of costs.

(a) In general.

* * * * *

(3) Coordination with § 1.482-1.

(4) Cross references.

* * * * *

(d) Costs.

* * * * *

(2) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation related to intangible development.

(iii) Measurement and timing of stock-based compensation expense.

(A) In general.

(*1*) Transfers to which section 421 applies.

(*2*) Deductions of foreign controlled participants.

(*3*) Modification of stock option.

(*4*) Expiration or termination of qualified cost sharing arrangement.

(B) Election with respect to options on publicly traded stock.

(C) Consistency.

(3) Examples.

* * * * *

Section 1.482-1 is amended by:

1. Revising the sixth sentence of paragraph (a)(1).

2. Adding a sentence following the sixth sentence of paragraph (a)(1).

3. Adding a sentence at the end of paragraph (b)(2)(i).

4. Adding a sentence at the end of paragraph (c)(1).

5. Adding paragraph (j)(5).

The additions and revisions read as follows:

§ 1.482-1 Allocation of income and deductions among taxpayers.

(a) * * *

(1) * * * Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. * * *

* * * * *

(b) * * *

(2) * * *

(i) * * * Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

(c) * * *

(1) * * * See § 1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

* * * * *

(j) * * *

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of § 1.482-5 are effective for taxable years beginning on or after the date of publication of the Treasury Decision incorporating those sentences into final regulations in the **Federal Register**.

Section 1.482-5 is amended by adding a sentence to paragraph (c)(2)(iv) to read as follows:

§ 1.482-5 Comparable profits method.

* * * * *

(c) * * *

(2) * * *

(iv) * * * As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by § 1.482-7(d)(2)(i)) among the tested party and comparable parties.

* * * * *

Section 1.482-7 is amended by:

1. Redesignating paragraph (a)(3) as paragraph (a)(4).

2. Adding paragraph (a)(3).

3. Redesignating paragraph (d)(2) as paragraph (d)(3).

4. Adding paragraph (d)(2).

5. Removing the word "and" at the end of paragraph (j)(2)(i)(D).

6. Removing the period and adding a semicolon and the word "and" at the end of paragraph (j)(2)(i)(E).

7. Adding paragraph (j)(2)(i)(F).

8. Revising paragraph (k).

The additions and revisions read as follows:

§ 1.482-7 Sharing of costs.

(a) * * *

(3) *Coordination with § 1.482-1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482-1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

(4) Cross references. * * *

* * * * *

(d) * * *

(2) *Stock-based compensation.* –

(i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development*. The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense*. –

(A) *In general*. Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies*. Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants*. Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as deductible by a foreign controlled participant otherwise not entitled to a deduction under United States income tax law as if the amount were paid or incurred by a United States taxpayer.

(*3*) *Modification of stock option*. Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then substantially vested within the meaning of § 1.83-3(b) (or, in the case of stock options to which section 421 applies, exercisable) and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(*4*) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then substantially vested within the meaning of § 1.83-3(b) (or, in the case of stock options to which section 421 applies, exercisable) and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock*. With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock. As used in this section, the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year. The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on the effective date of this paragraph (d)(2)(iii)(B), the election must be made by written amendment to the cost sharing agreement not later than the latest due date (without regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after the effective date of this paragraph, and the consent of the Commissioner is not required.

(C) *Consistency*. Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (d)(2)(iii)(B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

(3) *Examples*. * * *

* * * * *

(j) * * *

(2) * * *

(i) * * *

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of intangibles covered by the qualified cost sharing arrangement.

* * * * *

(k) *Effective date*. This section is generally effective for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section are effective for taxable years beginning on or after the date of publication of the Treasury Decision adopting those rules as final regulations in the **Federal Register**.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

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BILLING CODE 4830-01-P

APPENDIX F

Federal Register / Vol. 68, No. 165 / Tuesday, August 26, 2003 / Rules and Regulations **51171**

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9088]

RIN 1545-BA57

Compensatory Stock Options Under Section 482

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the application of the rules of section 482 governing qualified cost sharing arrangements. These regulations provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements and for purposes of the comparability factors to be considered under the comparable profits method.

DATES: *Effective Date:* These regulations are effective August 26, 2003.

Applicability Dates: For dates of applicability of these regulations, *see* §§ 1.482-1(j)(5) and 1.482-7(k).

FOR FURTHER INFORMATION CONTACT: Douglas Giblen, (202) 435-5265 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-1794. Responses to these collections of information are required by the IRS to monitor compliance with the federal tax rules for determining stock-based compensation costs to be shared among controlled participants in qualified cost sharing arrangements.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent or recordkeeper varies from 2 hours to 7 hours, depending on individual circumstances, with an estimated average of 4 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On July 29, 2002, Treasury and the IRS published in the **Federal Register** (67 FR 48997) proposed amendments to the regulations (REG-106359-02) under section 482 of the Internal Revenue Code (Code). These proposed regulations provide guidance regarding treatment of stock-based compensation for purposes of qualified cost sharing arrangements (QCSAs) and the comparable profits method and clarify the coordination of the rules regarding QCSAs with the arm's length standard. Written comments responding to these proposed regulations were received, and a public hearing was held on November 20, 2002. After consideration of all the comments, the proposed regulations under section 482 of the Code are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

These final regulations are the first in a series of regulatory guidance under section 482 through which Treasury and the IRS intend to update, clarify and improve current regulatory guidance in the transfer pricing area. A broader regulatory project on the treatment of QCSAs and a regulatory project on the transfer pricing of services are in progress, and Treasury and the IRS intend to issue proposed regulations with respect to each project in the near term.

These final regulations set forth explicit provisions clarifying that stock-based compensation is taken into account in determining the operating expenses treated as intangible development costs of a controlled participant in a QCSA under § 1.482-7. These final regulations provide rules for measuring the cost associated with stock-based compensation; clarify that the utilization and treatment of stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method under § 1.482-5; and provide rules that coordinate the rules of § 1.482-7 regarding QCSAs with the arm's length standard as set forth in § 1.482-1.

Treasury and the IRS received comments with respect to the proposed regulations. Most commentators objected to the proposed regulations in their entirety or suggested postponement of their finalization. Some commentators suggested modifications to be adopted in the event that the proposed regulations were finalized in some form.

After fully considering these comments, Treasury and the IRS continue to believe that the proposed regulations reflect a sound application of established principles under section 482. At the same time, Treasury and the IRS have concluded that certain suggested modifications to the administrative provisions of the proposed regulations are appropriate. These modifications are incorporated into the final regulations.

A. Stock-Based Compensation as a Cost To Be Shared and the Arm's Length Standard as Applied to QCSAs – §§ 1.482-7(d)(2)(i) and (a)(3), and 1.482-1(a)(1), (b)(2)(i) and (c)

A QCSA subject to the rules of § 1.482-7 is an arrangement to develop intangibles which meets certain administrative and other requirements and in which the participants to the arrangement share intangible development costs in proportion to their shares of reasonably anticipated benefits attributable to the intangibles developed under the arrangement. In the case of a QCSA, § 1.482-7(a)(2) limits the ability of the

Commissioner to make allocations, except to the extent necessary to make each controlled participant's share of the costs equal its share of reasonably anticipated benefits. An arrangement in which significant intangible development costs are not shared in proportion to reasonably anticipated benefits (or are not shared at all) would not in substance constitute an arrangement to which the rules of § 1.482-7 are applicable.

The proposed regulations address the treatment of stock-based compensation under a QCSA, and the interaction between the rules applicable to QCSAs and the arm's length standard. The proposed regulations provide that stock-based compensation related to the covered intangible development area must be taken into account in determining the costs to be shared by participants in a QCSA. The proposed regulations further provide that a QCSA produces results consistent with an arm's length result if, and only if, all costs related to the intangible development, as determined in accordance with the specific guidance in § 1.482-7(d), are shared in proportion to reasonably anticipated benefits.

Commentators objected to this rule on the basis of interpretations of the arm's length standard and on other grounds.

1. Comments Relating to Arm's Length Standard

Commentators asserted that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard unless there is evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Commentators asserted that third-party evidence, such as the government's own procurement contracting practices and agreements between unrelated parties with some characteristics similar to QCSAs, would show that parties at arm's length do not take stock-based compensation into account in determining costs to be reimbursed.

Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." *See* H.R. Conf. Rep. No. 99-481, at II-638 (1986). The regulations relating to QCSAs implement that legislative intent by using costs incurred by each controlled participant with respect to the intangible development as a proxy for actual economic activity undertaken by each, and by requiring each controlled participant to share these costs in proportion to its anticipated economic benefit from intangibles developed pursuant to the arrangement. In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the intangibles pursuant to the

QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.

Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Section 1.482-1(b)(1) provides that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances." (Emphasis added). While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. H.R. Rep. No. 99-426, at 423-25 (1985). 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. Government contractors that are entitled to reimbursement for services on a cost-plus basis under government procurement law assume substantially less entrepreneurial risk than that assumed by service providers that participate in QCSAs, and therefore the economic relationship between the parties to such an arrangement is very different from the economic relationship between participants in a QCSA. The other agreements highlighted by commentators establish arrangements that differ significantly from QCSAs in that they provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement. Such terms, which may have the effect of mitigating the impact of using a cost base to be shared or reimbursed that is less than comprehensive, would not be permitted by the QCSA regulations. Further, the QCSA regulations would not allow the Commissioner to impose such terms in the context of a QCSA.

The regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles. 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 in order to obtain the benefit of an independent right to exploit such 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.

For example, assume that two parties are negotiating an arrangement similar to a QCSA in order to attempt to develop patentable pharmaceutical products, and that they anticipate that they will benefit equally from their exploitation of such patents in their respective geographic markets. Assume further that one party is considering the commitment of several employees to perform research with respect to the arrangement. That party would not agree to commit employees to an arrangement that is based on the sharing of costs in order to obtain the benefit of independent exploitation rights unless the other party agrees to reimburse its share of the compensation costs of the employees. Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

An arrangement between controlled taxpayers for the development of intangible assets in which one taxpayer's share of significant costs exceeds its share of reasonably anticipated benefits from the exploitation of the developed intangibles would not in substance be a QCSA and therefore would be subject to analysis under the other section 482 regulations. For example, as in the transactions cited by commentators, a controlled taxpayer might agree at the outset of an arrangement to bear a disproportionate share of costs in an arrangement in which it receives a service fee or a contingent royalty from the exploitation of the developed intangibles. More generally, controlled taxpayers might agree at the outset of an arrangement to determine the compensation of one party based on a subset of that taxpayer's costs or on a basis that does not take that taxpayer's costs into account at all (*e.g.*, based on an amount determined with reference to a comparable uncontrolled price or transaction). In either case, such an arrangement between controlled taxpayers would not in substance constitute an arrangement to which the rules of § 1.482-7 would apply. Indeed, the limitations contained in § 1.482-7(a)(2) could produce results inconsistent with an arm's length result if applied to such an arrangement because the Commissioner would be precluded from making allocations that could be necessary to ensure that each controlled taxpayer is compensated appropriately. Rather, such an arrangement should be analyzed under the other section 482 regulations (in particular, sections 1.482-1, 1.482-2(b), and 1.482-4) to determine whether it reaches results consistent with the arm's length standard, and any allocations by the Commissioner should be consistent with such other section 482 regulations.

2. Other Comments

Commentators offered various other reasons for not taking stock-based compensation into account in the context of QCSAs. Commentators expressed the view that stock-based compensation should not be taken into account because it does not constitute an economic cost or require a cash outlay, or, to the extent such compensation does constitute a cost, because the cost is borne by shareholders whose share value is diluted when additional shares are issued on exercise. Commentators also noted that the treatment of stock-based compensation for financial reporting purposes should not mandate that stock-based compensation be taken into account in the context of QCSAs.

In response to such views, and as discussed above, Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for in the context of QCSAs is appropriate. The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard. Treasury and the IRS agree that the disposition of financial reporting issues does not mandate a particular result under these regulations.

One commentator suggested that even if stock-based compensation generates a cost to a participant, there is precedent within the regulations relating to QCSAs for excluding certain costs, notably interest and taxes. Treasury and the IRS believe that the technical treatment under the regulations relating to QCSAs of interest, taxes and other expenses not related to the intangible development area does not warrant failing to take into account an element of employee compensation that is clearly related to the intangible development area. Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity consistent with the legislative intent in this area, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. As noted above, Treasury and the IRS do not believe that there is a basis for distinguishing between stock-based compensation and other forms of compensation in this context.

One commentator also claimed that the historical administrative practice of the IRS has been not to challenge the failure to take stock-based compensation into account in other transfer pricing contexts in which the determination of cost is relevant. Treasury and the IRS believe that such perceived practices of the IRS with respect to other section 482 contexts are not relevant to determining the appropriate regulatory rule applicable to QCSAs.

As an alternate approach, one commentator suggested that rather than requiring stock-based compensation to be taken into account in the QCSA context, Treasury and the IRS should promulgate a "stock-based compensation safe harbor" applicable to QCSAs. This suggested "safe harbor" has not been adopted in the final regulations. As noted above, Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. The final regulations therefore require employee compensation to be taken into account, rather than provide for a safe harbor under which such compensation could be ignored.

B. Grant-Date Identification Rule – § 1.482-7(d)(2)(ii)

The proposed regulations identify the stock-based compensation to be included in the cost pool based on whether the compensation is related to the intangible development area on the date the option is granted.

One commentator noted that this identification rule is inconsistent with the IRS treatment of stock-based compensation in other tax areas such as sourcing, where IRS rulings trace the compensation to the entire period over which the employee performed the services compensated by the option.

The grant-date identification rule has been retained in the final regulations. As noted in the preamble of the proposed regulations, it is desirable in the QCSA context to select a single date for identification of covered stock-based compensation. The grant of compensation generally is the single economic event most closely associated with the services being compensated.

C. Provision of Specific Methods of Measurement and Timing

The proposed regulations prescribe two alternative methods for determining the operating expenses attributable to stock-based compensation. The default rule under § 1.482-7(d)(2)(iii)(A) provides that the costs attributable to stock-based compensation generally are included as intangible development costs upon the exercise of the option and measured by the spread between the option strike price and the price of the underlying stock. An elective rule under § 1.482-7(d)(2)(iii)(B) provides that the costs attributable to stock options are taken into account in certain cases in accordance with the "fair value" of the option, as reported for financial accounting purposes either as a charge against income or in footnoted disclosures.

Commentators claimed that parties at arm's length would not use either of the alternatives prescribed in the proposed regulations because they would produce results that are too speculative or not sufficiently related to the employee services that are compensated. One commentator suggested that the final regulations should not limit taxpayers to the two prescribed measurement methods but rather should codify the current IRS administrative practice of permitting any reasonable method. In the commentator's view, a standard based on any reasonable method should permit the intrinsic-value method, which measures the difference between strike price and underlying stock value at date of grant, exclusive of time value. However, the commentator suggested that if Treasury and the IRS consider an element of time value indispensable, an alternative would be to require the use of the "minimum value" method, which accounts for the time value of stock options by assuming the underlying stock will grow at the risk-free interest rate.

These suggestions were not adopted. Treasury and the IRS believe that it is appropriate for regulations to prescribe guidance in this context that is consistent with the arm's length standard and that also is objective and administrable. As long as the measurement method is determined at or before grant date, either of the prescribed measurement methods can be expected to result in an appropriate allocation of costs among QCSA participants and therefore would be consistent with the arm's length standard. The results under the default measurement rule are consistent with what would occur under an arm's length agreement at or before the grant date to take stock-based compensation into account at the date of exercise when more facts are known and therefore to share the risks associated with such compensation between the date of grant and the date of exercise. The results under the elective measurement rule are consistent with what would occur under an alternative arm's length agreement at or before the grant date to determine the value of the compensation up front and take such compensation into account at that time. With respect to the specific methods proposed by commentators, Treasury and the IRS believe that "intrinsic value" ignores significant elements of the economic value of stock-based compensation and "minimum value" ignores the important variable of volatility that enters into the economic pricing models used for financial reporting purposes.

The prescribed measurement methods are objective and administrable because they rely on valuations or measurements of stock-based compensation prepared for other purposes. The prescribed measurement methods do not require or permit valuations of stock-based compensation specifically for QCSA purposes. A standard under which the validity of the taxpayer's method would have to be analyzed on a case-by-case basis would be unduly difficult to administer and potentially could lead to significant disputes.

D. General Rule of Measurement – § 1.482-7(d)(2)(iii)(A)

Under the default measurement rule, the amount taken into account for QCSA purposes generally is the amount allowable as a federal income tax deduction on exercise of the stock-based compensation. This amount generally is the "spread" between the option price and the fair market value of the underlying stock at the date of exercise.

One commentator suggested that this method would be improved if the amount taken into account for QCSA purposes were limited to the portion of the spread that accrued between date of grant and full vesting, as further prorated to reflect only the time during which the employee was engaged in cost-shared activities.

This suggestion has not been adopted in the final regulations. Treasury and the IRS believe that the grant-date identification rule already limits in an appropriate way the stock-based compensation taken into account. The purpose of the default measurement rule is to measure the amount attributable to stock-based compensation that must be taken into account under the grant-date identification rule. Accordingly, the default measurement rule does not require further refinement through proration. Further, additional recordkeeping and analysis necessary to identify relevant time periods and employee activities involving the covered intangibles and to perform proration calculations are not warranted.

The proposed regulations set forth special rules for the application of the general rule of measurement in the event of modification of a stock option and expiration or termination of a QCSA. The final regulations retain these rules with technical modifications.

E. Treatment of Statutory Stock Options – § 1.482-7(d)(2)(iii)(A)(1)

Under the default measurement rule in the proposed regulations, a special rule applies to statutory stock options (also referred to as incentive and employee stock purchase plan stock options). Under this special rule, the spread on statutory stock options generally is taken into account for QCSA purposes on exercise, even though section 421 denies a deduction with respect to statutory stock options unless and until there is a disqualifying disposition of the underlying stock by the employee.

One commentator suggested that the special rule for statutory stock options should be removed because it imposes an unnecessary administrative burden on taxpayers to apply different rules for different purposes. This suggestion was not adopted in the final regulations. Treasury and the IRS believe that the more important concern is consistent treatment of statutory and nonstatutory stock options for this purpose. This consistency is achieved only if the spread on both statutory and nonstatutory options is included in the cost pool on exercise.

F. Elective Method of Measurement – § 1.482-7(d)(2)(iii)(B)

The proposed regulations permit an elective method of measurement and timing with respect to options on publicly traded stock of companies subject to financial reporting under U.S. generally accepted accounting principles (U.S. GAAP), provided that the stock is traded on a U.S. securities market. Under the election, the amount taken into account for QCSA purposes associated with compensatory stock options is their "fair value," generally measured by reference to economic pricing models as of the date of grant, as reflected either as a charge against income or as a footnote disclosure in the company's audited financial statements, in compliance with current U.S. GAAP.

One commentator proposed that the elective measurement method be made available to all taxpayers. The commentator further suggested that controlled participants should be permitted to use any reasonable method to measure stock-based compensation in the form of options on stock of foreign corporations as long as that method is consistent with international accounting standards or with accounting principles that are prevalent in the home country of the controlled participant. In the commentator's view, the limitations in the proposed regulations are not justified by difficulty of valuation and may be vulnerable to challenges under anti-discrimination clauses in U.S. income tax treaties.

Treasury and the IRS agree that the elective method should be more broadly available and have modified these rules in the final regulations. Specifically, the final regulations extend the availability of the elective method to options on the stock of certain companies that prepare their financial statements in accordance with accounting principles other than U.S. GAAP, while continuing to limit the availability of the elective method to options on stock that is publicly traded on a U.S. securities market. Thus, the availability of the elective method is not extended to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

Treasury and the IRS believe that objectivity and ease of administration are important features of any method of measuring costs attributable to stock-based compensation for purposes of QCSAs. The elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Treasury and the IRS recognize that foreign-based companies whose stock is traded on a U.S. securities market (directly or through the use of American Depository Receipts) are required to determine the fair value of options on their stock even though they do not necessarily prepare financial statements in accordance with U.S. GAAP. Companies satisfy that requirement by preparing financial statements in accordance with a comprehensive body of generally accepted accounting principles (GAAP) that is consistent with the U.S. GAAP requirement of determining the fair value of stock options, or by preparing reconciliations of their financial statements with U.S. GAAP in a manner that reflects the fair value of stock options.

Accordingly, the final regulations provide that in determining eligibility for the elective method, financial statements prepared in accordance with GAAP other than U.S. GAAP are considered as prepared in accordance with U.S. GAAP in two circumstances. First, financial statements are considered as prepared in accordance with U.S. GAAP where the fair value of stock options is reflected in a legally required reconciliation between the applicable GAAP and U.S. GAAP. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such reconciliation.

Second, financial statements are considered as prepared in accordance with U.S. GAAP where, under the applicable GAAP, the fair value of stock options is reflected as a charge against income in audited financial statements or is disclosed in footnotes to such statements. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such audited financial statements.

Treasury and the IRS continue to believe that the elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Accordingly, the final regulations do not extend the availability of the elective method to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

One commentator suggested that the election to use the elective method should be made on the taxpayer's return rather than evidenced in the written cost sharing agreement. In the view of the commentator, such a procedure would be more practical from an enforcement perspective.

This suggestion was not adopted. Treasury and the IRS continue to believe that the most effective way to ensure that all participants are bound by the election is to incorporate it within the written cost sharing agreement.

G. Modification of Comparable Profits Method – § 1.482-5(c)(2)(iv)

The proposed regulations provide that in applying the comparable profits method, if there are material differences among the tested party and uncontrolled comparables with respect to the utilization or treatment of stock-based compensation, such material differences are an appropriate basis for comparability adjustments. One commentator expressed the view that this provision contradicts the arm's length coordination rules for QCSAs because the treatment of stock-based compensation by unrelated parties is considered relevant for purposes of the comparable profits method but not relevant for purposes of QCSAs.

No revision was made in response to this comment. Treasury and the IRS believe that the rule provided in the proposed regulations with respect to the application of the comparable profits method is appropriate because the financial data with respect to similar business activities that generally is used as a reference point for that method is subject to adjustment to ensure comparability.

H. Effective Date and Transition Rules – § 1.482-7(k) and (d)(2)(iii)(B)(2)

The provisions of the proposed regulations applicable to QCSAs would apply to stock-based compensation granted in taxable years beginning on or after publication of final regulations. Participants in a QCSA in existence on the effective date may, on a one-time basis, amend their agreement to elect the grant-date method of measurement without the Commissioner's consent. The election with respect to existing QCSAs must be made not later than the latest due date, without regard to extensions, for an income tax return of a controlled participant for the first taxable year beginning after the effective date of final regulations.

One commentator stated that the prospective effective date does not afford taxpayers a reasonable time to amend their cost sharing agreements or restructure complex international operations. A transition period of two years after the publication of final regulations was suggested.

This suggestion was not adopted. Treasury and the IRS consider the period stated in the proposed regulations adequate for the initial planning and recordkeeping that may be occasioned by the final regulations.

With respect to the special transition rule permitting taxpayers to elect the grant-date method of measurement by amendment of an existing written cost sharing agreement no later than the latest due date of an income tax return of a controlled participant, one commentator suggested that the due date should not disregard filing extensions. The commentator maintained that fairness dictates affording taxpayers this extra time for the analysis needed to make this significant decision.

In response to this comment, the final regulations provide that the due date for amendments to existing cost sharing agreements is determined with regard to filing extensions.

Some commentators urged Treasury and the IRS to postpone finalization of the proposed regulations until the OECD completes its ongoing consideration of the treatment of stock options for transfer pricing purposes and an international consensus begins to form so that the potential for international disputes and resulting negative effects on U.S. business can be minimized. Similarly, a commentator suggested that the effects of applying the principles of the proposed regulations to other areas of transfer pricing should be thoroughly studied and harmonized before finalizing the regulations to avoid creating traps for the unwary or other unforeseen consequences.

These suggestions were not implemented. Treasury and the IRS do not believe that international discussion of issues compels the suspension of the regulatory process. Also, Treasury and the IRS believe that it is important to provide timely guidance on issues such as those addressed by the proposed and final regulations.

Finally, the preamble to the proposed regulations states that the proposed regulations clarify that stock-based compensation must be taken into account in the QCSA context. Several commentators interpreted this language as in effect requiring the new rules to be applied retroactively. These commentators urged that the final regulations contain further assurances of prospective intent and explicitly recognize that these regulations represent a fundamental change to the traditional approach to section 482.

No revisions were made in light of these comments. As noted earlier, Treasury and the IRS believe that requiring stock-based compensation to be taken into account in the QCSA context is consistent with the arm's length standard and long-standing policies underlying section 482. The final regulations, like the proposed regulations, clearly specify that the specific rules provided therein are prospective in application. Moreover, as stated in the proposed regulations, while taxpayers may rely on the proposed regulations until the effective date of the final regulations, no inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of these final regulations.

I. Paperwork Reduction Act and Regulatory Flexibility Act

One commentator expressed the view that the compliance burden imposed by the proposed regulations on each taxpayer will significantly exceed the two to seven hours estimated under the Paperwork Reduction Act. The commentator also asserted that the estimated number of taxpayers affected by the rules was too low.

The burden estimates as stated in the final regulations reflect no change. Treasury and the IRS reviewed the estimates made in the proposed regulations and concluded that they are reasonable.

Similarly, with respect to the Regulatory Flexibility Act, the commentator challenged the statement in the preamble of the proposed regulations that the new regulatory requirements will not have a significant economic impact on a substantial number of small entities. Upon review of available information, Treasury and the IRS found no basis for a change in the statement or in the operative finding that the economic impact of the collections of information in the proposed regulations is not significant with respect to small entities.

J. Documentation Requirements and Other Provisions on Which No Comments Received

Section 1.482-7(j)(2)(i)(F) of the proposed regulations requires that controlled participants maintain specific documentation to establish the amount attributable to stock-based compensation that is taken into account in determining the costs to be shared, including the method of measurement and timing used with respect to that amount. No comments were received on this particular provision, and it is retained in the final regulations.

Treasury and the IRS intend that this provision will require controlled participants that use the elective method of measurement to maintain documentation establishing compliance with the requirements of § 1.482-7(d)(2)(iii)(B). For example, documentation should establish that applicable financial statements reflecting the value of stock options with respect to which the elective method is used, as well as applicable accounting principles under which such financial statements are prepared, are in conformity with the fair-value and reconciliation requirements adopted in the final regulations with respect to GAAP other than U.S. GAAP.

Several other provisions of the proposed regulations similarly were not commented upon and have been adopted without modification in the final regulations. These provisions include § 1.482-7(d)(2)(iii)(A)(*2*), relating to deductions of foreign controlled participants; the last sentence of § 1.482-7(d)(2)(ii), relating to repricing and other modifications of stock options; and § 1.482-7(d)(2)(iii)(C), providing consistency rules for measurement and timing of stock-based compensation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to enter into QCSAs involving stock-based compensation, and that for those who do, the burdens imposed under § 1.482-7(d)(2)(iii)(B) and (j)(2)(i)(F) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Douglas Giblen of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1 – INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ Sections 1.482-1, 1.482-5 and 1.482-7 also issued under 26 U.S.C. 482. * * *

■ **Par. 2.** Section 1.482-0 is amended by:

■ 1. Redesignating the entry for § 1.482-7(a)(3) as the entry for § 1.482-7(a)(4).

■ 2. Adding a new entry for § 1.482-7(a)(3).

■ 3. Redesignating the entry for § 1.482-7(d)(2) as the entry for § 1.482-7(d)(3).

■ 4. Adding new entries for § 1.482-7(d)(2).

The additions and redesignation read as follows:

§ 1.482-0 Outline of regulations under section 482.

* * * * *

§ 1.482-7 Sharing of costs.

(a) In general.

* * * * *

(3) Coordination with § 1.482-1.

(4) Cross references.

* * * * *

(d) Costs.

* * * * *

(2) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation related to intangible development.

(iii) Measurement and timing of stock-based compensation expense.

(A) In general.

(*1*) Transfers to which section 421 applies.

(*2*) Deductions of foreign controlled participants.

(*3*) Modification of stock option.

(*4*) Expiration or termination of qualified cost sharing arrangement.

(B) Election with respect to options on publicly traded stock.

(*1*) In general.

(*2*) Publicly traded stock.

(*3*) Generally accepted accounting principles.

(*4*) Time and manner of making the election.

(C) Consistency.

(3) Examples.

* * * * *

■ **Par. 3.** Section 1.482-1 is amended by:

■ 1. Removing the sixth sentence of paragraph (a)(1) and adding two sentences in its place.

■ 2. Adding a sentence at the end of paragraph (b)(2)(i).

■ 3. Adding a sentence at the end of paragraph (c)(1).

■ 4. Adding paragraph (j)(5).

The additions read as follows:

§ 1.482-1 Allocation of income and deductions among taxpayers.

(a) * * *

(1) * * * Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. * * *

* * * * *

(b) * * *

(2) * * *

(i) * * * Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

(c) * * *

(1) * * * See § 1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

* * * * *

(j) * * *

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of § 1.482-5 apply for taxable years beginning on or after August 26, 2003.

■ **Par. 4.** Section 1.482-5 is amended by adding a sentence at the end of paragraph (c)(2)(iv) to read as follows:

§ 1.482-5 Comparable profits method.

* * * * *

(c) * * *

(2) * * *

(iv) * * * As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by § 1.482-7(d)(2)(i)) among the tested party and comparable parties.

* * * * *

■ **Par. 5.** Section 1.482-7 is amended by:

■ 1. Redesignating paragraph (a)(3) as paragraph (a)(4).

■ 2. Adding a new paragraph (a)(3).

■ 3. Redesignating paragraph (d)(2) as paragraph (d)(3).

■ 4. Adding a new paragraph (d)(2).

■ 5. Removing the word "and" at the end of paragraph (j)(2)(i)(D).

■ 6. Removing the period at the end of paragraph (j)(2)(i)(E) and adding "; and" in its place.

■ 7. Adding paragraph (j)(2)(i)(F).

■ 8. Revising paragraph (k).

The additions and revision read as follows:

§ 1.482-7 Sharing of costs.

(a) * * *

(3) *Coordination with § 1.482-1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482-1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

* * * * *

(d) * * *

(2) *Stock-based compensation* –

(i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development*. The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense* –

(A) *In general*. Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for Federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies*. Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants*. Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option*. Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(*4*) *Expiration or termination of qualified cost sharing arrangement*. Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock* –

(1) *In general*. With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock*. As used in this paragraph (d)(2)(iii)(B), the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles*. For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either –

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election*. The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) *Consistency*. Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(*2*) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

* * * * *

(j) * * *

(2) * * *

(i) * * *

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of covered intangibles.

* * * * *

(k) *Effective date.* This section applies for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

* * * * *

PART 602 – OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 9.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

■ **Par. 10.** In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read in part as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.482-7	1545-1794
* * * * *	

Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

Approved: August 11, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

[FR Doc. 03-21355 Filed 8-25-03; 8:45 am]

BILLING CODE 4830-01-P

APPENDIX G

FOR PUBLICATION

**UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT**

Altera Corporation & Subsidiaries, *Petitioner-Appellee*, v. Commissioner of Internal Revenue, *Respondent-Appellant*.	Nos. 16-70496 16-70497 Tax Ct. Nos. 6253-12 9963-12 OPINION

Appeal from Decisions of the
United States Tax Court

Argued and Submitted October 11, 2017
San Francisco, California

Filed July 24, 2018

Before: Sidney R. Thomas, Chief Judge,
and Stephen Reinhardt* and Kathleen M. O'Malley**
Circuit Judges.

Opinion by Chief Judge Thomas;
Dissent by Judge O'Malley

---

* Judge Reinhardt fully participated in this case and formally concurred in the majority opinion prior to his death.

** The Honorable Kathleen M. O'Malley, United States Circuit Judge for the U.S. Court of Appeals for the Federal Circuit, sitting by designation.

SUMMARY***

Tax

The panel reversed a decision of the Tax Court that 26 C.F.R. § 1.482-7A(d)(2), under which related entities must share the cost of employee stock compensation in order for their cost-sharing arrangements to be classified as qualified cost-sharing arrangements and thus avoid an IRS adjustment, was invalid under the Administrative Procedure Act. The panel reasoned that the Commissioner of Internal Revenue did not exceed the authority delegated to him by Congress under 26 U.S.C. § 482, that the Commissioner's rule-making authority complied with the Administrative Procedure Act, and that therefore the regulation is entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

Dissenting, Judge O'Malley would find, as the Tax Court did, that 26 C.F.R. § 1.482-7A(d)(2) is invalid as arbitrary and capricious.

COUNSEL

Arthur T. Catterall (argued), Richard Farber, and Gilbert S. Rothenberg, Attorneys; Diana L. Erbsen, Deputy Assistant Attorney General; Caroline D. Ciraolo, Acting Assistant Attorney General; Tax Division,

*** This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

United States Department of Justice, Washington, D.C.; for Respondent-Appellant.

Donald M. Falk (argued), Mayer Brown LLP, Palo Alto, California; Thomas Kittle-Kamp and William G. McGarrity, Mayer Brown LLP, Chicago, Illinois; Brian D. Netter and Travis Crum, Mayer Brown LLP, Washington, D.C.; A. Duane Webber, Phillip J. Taylor, and Joseph B. Judkins, Baker & McKenzie LLP, Washington, D.C.; for Petitioner-Appellee.

Susan C. Morse, University of Texas School of Law, Austin, Texas; Stephen E. Shay, Harvard Law School, Cambridge, Massachusetts; for Amici Curiae J. Richard Harvey, Leandra Lederman, Ruth Mason, Susan Morse, Stephen Shay, and Bret Wells.

Jonathan E. Taylor, Gupta Wessler PLLC, Washington, D.C.; Clint Wallace, Vanderbilt Hall, New York, New York; for Amici Curiae Anne Alstott, Reuven Avi-Yonah, Lily Batchelder, Joshua Blank, Noel Cunningham, Victor Fleischer, Ari Glogower, David Kamin, Mitchell Kane, Sally Katzen, Edward Kleinbard, Michael Knoll, Rebecca Kysar, Zachary Liscow, Daniel Shaviro, John Steines, David Super, Clint Wallace, and George Yin.

Larissa B. Neumann, Ronald B. Schrotenboer, and Kenneth B. Clark, Fenwick & West LLP, Mountain View, California, for Amicus Curiae Xilinx Inc.

Christopher J. Walker, The Ohio State University Moritz College of Law, Columbus, Ohio; Kate Comerford Todd, Steven P. Lehotsky, and Warren Postman, U.S. Chamber Litigation Center, Washington, D.C.; for Amicus Curiae Chamber of Commerce of the

United States of America. John I. Forry, San Diego, California, for Amicus Curiae TechNet.

Alice E. Loughran, Michael C. Durst, and Charles G. Cole, Steptoe & Johnson LLP, Washington, D.C.; Bennett Evan Cooper, Steptoe & Johnson LLP, Phoenix, Arizona; for Amici Curiae Software and Information Industry Association, Financial Executives International, Information Technology Industry Council, Silicon Valley Tax Directors Group, Software Finance and Tax Executives Counsel, National Association of Manufacturers, American Chemistry Council, BSA | the Software Alliance, National Foreign Trade Council, Biotechnology Innovation Organization, Computing Technology Industry Association, The Tax Council, United States Council for International Business, Semiconductor Industry Association.

Kenneth P. Herzinger and Eric C. Wall, Orrick Herrington & Sutcliffe LLP, San Francisco, California; Peter J. Connors, Orrick Herrington & Sutcliffe LLP, New York, New York; for Amici Curiae Charles W. Calomiris, Kevin H. Hassett, and Sanjay Unni.

Roderick K. Donnelly and Neal A. Gordon, Morgan Lewis & Bockius LLP, Palo Alto, California; Thomas M. Peterson, Morgan Lewis & Bockius LLP, San Francisco, California; for Amicus Curiae Cisco Systems Inc.

Christopher Bowers, David Foster, Raj Madan, and Royce Tidwell, Skadden Arps Slate Meagher & Flom LLP, Washington, D.C.; Nathaniel Carden, Skadden Arps Slate Meagher & Flom LLP, Chicago, Illinois; for Amicus Curiae Amazon.com Inc.

OPINION

THOMAS, Chief Judge:

In this case, we consider the validity of 26 C.F.R. § 1.482-7A(d)(2),[1] under which related entities must share the cost of employee stock compensation in order for their cost-sharing arrangements to be classified as qualified cost-sharing arrangements ("QCSA") and thus avoid an IRS adjustment. We conclude that the regulations withstand scrutiny under general administrative law principles, and we therefore reverse the decision of the Tax Court.

I

Corporations often elect to conduct business through international subsidiaries. Transactions between related companies can provide opportunities for minimizing or avoiding taxes, particularly when a foreign subsidiary is located in a low tax jurisdiction. For example, a parent company in a high tax jurisdiction can sell property to its subsidiary in a low tax jurisdiction and have its subsidiary sell the property for profit. The profits from those sales are thus taxed in a lower tax jurisdiction, resulting in significant tax savings for the parent. This practice, known as "transfer pricing" can result in United States companies shifting profits that would be subject to tax in America offshore to avoid tax. Similarly, related companies can identify and shift costs between American and foreign jurisdictions to minimize tax exposure. In recent years, United States corporations have used

[1] The 2003 amendments to Treasury's cost-sharing regulations are at issue. Although they are still in effect, the Code has been reorganized, and what was § 1.482-7 in 2003 is now numbered § 1.482-7A. To minimize confusion, our citations are to the current version of the regulations unless otherwise specified.

these techniques to develop intangible property with their foreign subsidiaries, and to share the cost of development between the companies. Under these arrangements, a U.S. corporation might enter into a research and development ("R&D") cost-sharing agreement with its foreign subsidiary located in a low tax jurisdiction and grant the offshore company rights to exploit the property internationally. The interplay of cost and income allocation between the two companies in such a transaction can result in significantly reduced taxes for the United States parent.

To address the risk of multinational corporation tax avoidance, Congress passed legislation granting the United States Department of the Treasury the authority to allocate income and costs between such related parties. 26 U.S.C. § 482. In turn, the Secretary of the Treasury promulgated regulations authorizing the Commissioner of the Internal Revenue Service to allocate income and costs among these related entities. 26 C.F.R. §§ 1.482-0 through 1.482-9.

At issue before us are employee stock options, the cost of which the companies in this case elected not to share, resulting in substantial tax savings for the parent – here, the tax associated with over $80 million in income. The Commissioner contends that allocation of stock compensation costs between the companies is appropriate to reflect economic reality; Altera Corporation ("Altera") and its subsidiaries contend that any cost allocation exceeds the Commissioner's authority.

Fundamental to resolution of this dispute is an understanding of the arm's length standard, a tool that Treasury developed in the mid-twentieth century to ensure that controlled taxpayers were taxed similarly to uncontrolled taxpayers. The arm's length standard is results-oriented, meaning that its goal is parity in taxable income rather than parity in the method of allocation itself. 26 C.F.R. § 1.482-1(b)(1) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."). A traditional arm's length analysis looks to comparable transactions among non-related parties to achieve an arm's length result. The issue in this case is whether Treasury can permissibly allocate between related parties a cost that unrelated parties do not agree to share.

Altera asserts that the arm's length standard always demands a comparability analysis, meaning that the Commissioner cannot allocate costs between related parties in the absence of evidence that unrelated parties share the same costs when dealing at arm's length. Altera argues that, because uncontrolled taxpayers do not share the cost of employee stock options, the Commissioner cannot require related parties to share that cost.

The Commissioner argues that he may, consistent with the arm's length standard, apply a purely internal method of allocation, distributing the costs of employee stock options in proportion to the income enjoyed by each controlled taxpayer. This "commensurate with income" method analyzes the income generated by intangible property in comparison with the amount paid (usually as royalty) to the parent. In the Commissioner's view, the commensurate with income method is consistent with the arm's length standard because controlled cost-sharing arrangements have no equivalent in uncontrolled arrangements, and Congress has provided that the Commissioner may dispense with a comparability analysis where comparable transactions do not exist in order to achieve an arm's length result.

Because this case involves a challenge to regulations, the ultimate issue is not what the arm's length standard should mean but rather whether Treasury may define the standard as it has. We conclude that the challenged regulations are not arbitrary and capricious but rather a reasonable execution of the authority delegated by Congress to Treasury.

II

At issue is Altera's tax liability for the years 2004 through 2007. During the relevant period, Altera and its subsidiaries designed, manufactured, marketed, and sold programmable logic devices, electronic components that are used to build circuits.

In May of 1997, Altera entered into a cost-sharing agreement with one of its subsidiaries, Altera International, Inc., a Cayman Islands corporation ("Altera International"), which had been incorporated earlier that year. Altera granted to Altera International a license to use and exploit Altera's preexisting intangible property everywhere in the world except the United States and Canada. In exchange, Altera International paid royalties to Altera. The parties agreed to pool their resources to share R&D costs in proportion to the benefits anticipated from new technologies.

Altera and the IRS agreed to an Advance Pricing Agreement covering the 1997-2003 tax years. Pursuant to this agreement, and consistent with the cost-sharing regulations in effect at the time, Altera shared with Altera International stock-based compensation costs as part of the shared R&D costs. The Treasury regulations were amended in 2003, and Altera and Altera International amended their cost-sharing agreement to comply with the modified regulations, continuing to share employee stock compensation costs.

The agreement was amended again in 2005 following the Tax Court's opinion in *Xilinx, Inc. v. Commissioner*, involving a challenge to the allocation of employee stock compensation costs under the 1994-1995 cost-sharing regulations. 125 T.C. 37 (2005). The parties agreed to "suspend the payment of any portion of [a] Cost Share . . . to the extent such payment relates to the Inclusion of Stock-Based Compensation in R&D Costs" unless and until a court upheld the validity of the 2003 cost-sharing regulations. The following provision explains Altera's reasoning:

> The Parties believe that it is more likely than not that (i) the Tax Court's conclusion in *Xilinx Inc. v. Comm'r*, 125 T.C. [No.] 4 (2005), that the arm's length standard controls the determination of costs to be shared by controlled participants in a qualified cost sharing arrangement should also apply to Treas. Reg. § 1.482-7A(d)(2) (as amended by T.D. 9088), and (ii) the Parties' inclusion of Stock-Based Compensation in R&D Costs pursuant to Amendment I would be contrary to the arm's length standard.

Altera and its U.S. subsidiaries did not account for R&D-related stock-based compensation costs on their consolidated 2004-2007 federal income tax returns. The IRS issued two notices of deficiency to the group, applying § 1.482-7(d)(2) to increase the group's income by the following amounts:

2004	$ 24,549,315
2005	$ 23,015,453
2006	$ 17,365,388
2007	$ 15,463,565

The Altera group timely filed petitions in the Tax Court. The parties filed cross-motions for partial summary judgment, and the Tax Court granted Altera's motion. Sitting en banc, the court held that § 1.482-7A(d)(2) is invalid under the Administrative Procedure Act ("APA"). *Altera Corp. & Subsidiaries v. Comm'r*, 145 T.C. 91 (2015).

The Tax Court unanimously determined that the Commissioner's allocation of income and expenses between related entities must be consistent with the arm's length standard, and that the arm's length standard is not met unless the Commissioner's allocation can be compared to an actual transaction between unrelated entities. The court reasoned that the Commissioner could not require related parties to share stock compensation costs because the Commissioner had not considered any unrelated party transactions in which the parties shared such costs. The court concluded that the agency decision-making process was fundamentally flawed because: (1) it rested on speculation rather than hard data and expert opinions; and (2) it failed to respond to significant public comments, particularly those identifying uncontrolled cost-sharing arrangements in which the entities did not share stock compensation costs. *Altera*, 145 T.C. at 122-31.

The Tax Court's decision rested largely on its own opinion in *Xilinx*, in which it held that "the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances." *Id.* at 118 (citing *Xilinx*, 125 T.C. at 53-55). In its decision in this case, the Tax Court reinforced its conclusion that the Commissioner cannot require related entities to share stock compensation costs unless and until it locates uncontrolled transactions in which these costs are shared. *Id.* at 118-19.

The court reached five holdings: (1) that the 2003 amendments constitute a final legislative rule subject to the requirements of the APA; (2) that *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Auto Insurance Co.*, 463 U.S. 29 (1983) provides the appropriate standard of review because the standard set forth in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), incorporates *State Farm*'s reasoned decisionmaking standard; (3) that Treasury failed to adequately support its decision to allocate the costs of employee stock compensation between related parties; (4) that Treasury's failure was not harmless error; and (5) that § 1.482-7A(d)(2) is invalid under the APA. *Id.* at 115-33.

On appeal, the Commissioner does not dispute the first holding regarding the applicability of *State Farm*, although he argues that the appropriate standard is more deferential and less empirically minded than the standard actually applied by the Tax Court. Nor does he claim that any error in the decisionmaking process, if it existed, was harmless. The challenged holdings – (2), (3), and (5) – are all part of the same broader question: did Treasury exceed its authority in requiring Altera's cost-sharing arrangement to include a particular distribution of employee stock compensation costs?

III

The Commissioner's position is founded on 26 U.S.C. § 482. Because an understanding of § 482 and its history is integral to resolution of each of the issues raised by the parties, a brief overview of the statute and its history is important.

At the relevant time,[2] 26 U.S.C. § 482 appeared to provide a nearly limitless grant of authority to Treasury to allocate income between related parties:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The first sentence has remained substantively unchanged since 1928, Revenue Act of 1928, ch. 852,

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[2] Section 482 was amended in December 2017 to include a third sentence:

> For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054. Because the amendment postdates the operative regulations, it does not affect our analysis.

§ 45, 45 Stat. 791, 806 (1928), and it provides the statutory authority for the arm's length standard, which first appeared in the 1934 tax regulations, Regulations 86, Art. 45-1(b) (1935). The second sentence sets forth the commensurate with income standard, and it was added to the statute in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562 (1986).

A

From the beginning, § 482's precursor was designed to give Treasury the flexibility it needed to prevent cost and income shifting between related entities for the purpose of decreasing tax liability. *See* H.R. Rep. No. 70-2, at 16-17 (1927) ("[T]he Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability."); *accord* S. Rep. No. 70-960, at 24 (1928). The purpose of the statute is "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer . . . ." *Comm'r v. First Sec. Bank of Utah*, 405 U.S. 394, 400 (1972) (quoting Treas. Reg. § 1.482-1(b)(1) (1971)). This parity is double-edged: as much as § 482 works to ensure controlled taxpayers are not overtaxed, the concern expressed on the face of § 482, even before the 1986 amendment, is preventing tax avoidance by controlled taxpayers.

After 1934, when the arm's length standard appeared in the regulations – in what is essentially its modern form – courts did not hold related parties to the standard by looking for comparable transactions. For example, in *Seminole Flavor Co. v. Commissioner*, the Tax Court rejected a strict application of the arm's length standard in favor of an inquiry into whether the allocation of income between related parties was "fair and reasonable." 4 T.C. 1215, 1232 (1945); *see also id.* at 1233 ("Whether any such business agreement would have been entered into by petitioner with total strangers is wholly problematical."); *Grenada Indus., Inc. v. Comm'r*, 17 T.C. 231, 260 (1951) ("We approve an allocation . . . to the extent that such gross income in fact exceeded the fair value of services rendered . . . ."). And in 1962, this Court collected various allocation standards and outright rejected the superiority of the arm's length standard over all others:

> [W]e do not agree . . . that "arm's length bargaining" is the sole criterion for applying the statutory language of § 45 in determining what the "true net income" is of each "controlled taxpayer." Many decisions have been reached under § 45 without reference to the phrase "arm's length bargaining" and without reference to Treasury Department Regulations and Rulings which state that the talismanic combination of words – "arm's length" – is the "standard to be applied in every case."
>
> For example, it was not any less proper . . . to use here the "reasonable return" standard than it was for other courts to use "full fair value," "fair price including a reasonable profit," "method which seems not unreasonable," "fair consideration which reflects arm's length dealing," "fair and reasonable," "fair and reasonable" or "fair and fairly arrived at," or "judged as to fairness," all used in interpreting § 45.

Frank v. Int'l Canadian Corp., 308 F.2d 520, 528-29 (9th Cir. 1962) (footnotes omitted).[3]

In the 1960s, the problem of abusive transfer pricing practices created a new adherence to a stricter arm's length standard. In response to concerns about the undertaxation of multinationals, Congress considered reworking the Code to resolve the difficulty posed by the application of the arm's length standard to related party transactions. H.R. Rep. No. 87-1447, at 28-29 (1962). However, it instead asked Treasury to "explore the possibility of developing and promulgating regulations . . . which would provide additional guidelines and formulas for the allocation of income and deductions" under § 482. H.R. Conf. Rep. No. 87-2508, at 19 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3732, 3739. Legislators believed that § 482, at least in theory, authorized the Secretary to employ a profit-split allocation method without amendment. *Id.*; H.R. Rep. No. 87-1447, at 28-29 ("This provision appears to give the Secretary the necessary authority to allocate income between a domestic parent and its foreign subsidiary.").

In 1968, following Congress's entreaty, Treasury finalized the first regulation tailored to the issue of intangible property development in cost-sharing arrangements. Treas. Reg. § 1.482-2(d) (1968). The novelty of the 1968 regulations was their focus on comparability. *Compare* Treas. Reg. § 1.482-2(d)(2) ("An arm's length consideration shall be in a form which is consistent with the form which would be

[3] The Court later took a hard turn from the flexibility it welcomed in *Frank*, which it limited to situations in which "it would have been difficult for the court to hypothesize an arm's-length transaction." *Oil Base, Inc. v. Comm'r*, 362 F.2d 212, 214 n.5 (9th Cir. 1966).

adopted in transactions between unrelated parties in the same circumstances.") *with* Regulations 86, Art. 45-1(b) (1935) (focusing on arm's length results rather than arm's length form). The 1968 regulations "constituted a radical and unprecedented approach to the problem they addressed – notwithstanding their being couched in terms of the 'arm's length standard,' and notwithstanding that that standard had been the nominal standard under the regulations for some 30 years . . . ." Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 644 (1986).

Despite the asserted focus on comparability, the arm's length standard has never been used to the exclusion of other, more flexible approaches. Indeed, a study determined that direct comparables were located and applied in only 3% of IRS's adjustments prior to the 1986 amendment. U.S. Gen. Accounting Office, GGD-81-81, IRS Could Better Protect U.S. Tax Interests In Determining The Income Of Multinational Corporations 29 (1981). The decades following the 1968 regulations involved

> a gradual realization by all parties concerned, but especially Congress and the IRS, that the [arm's length standard], firmly established . . . as the sole standard under section 482, did not work in a large number of cases, and in other cases its misguided application produced inappropriate results. The result was a deliberate decision to retreat from the standard while still paying lip service to it.

Reuven S. Avi-Yonah, *The Rise & Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 Va. Tax Rev. 89, 112 (1995); *see also* James P. Fuller, *Section 482: Revisited Again*, 45 Tax

L. Rev. 421, 453 (1990) ("[T]he 1986 Act's commensurate with income standard is not really a new approach to § 482."). The arm's length standard had proven to be similarly illusory in international contexts. Langbein, *supra*, at 649.

B

As controlled transactions increased in frequency and complexity, Congress determined that legislative action was necessary. The Tax Reform Act of 1986 reflected Congress's view that strict adherence to the arm's length standard prevented tax parity.

The House Ways and Means Committee recommended the addition of the commensurate with income clause because it was "concerned" that the current statute and regulations "may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles . . . ." H.R. Rep. No. 99-426, at 423 (1985). The clause was intended to correct a "recurrent problem" – "the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables." *Id.* at 423-24.

Congress intended the commensurate with income standard to displace a comparability analysis where comparable transactions cannot be found:

> A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. . . . [M]ultinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries.
>
> . . .
>
> Certain judicial interpretations of section 482 suggest that pricing arrangements between unrelated

> parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. . . . [S]uch an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles is necessary.
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> . . .
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> . . . There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation . . . be commensurate with the income attributable to the intangible. . . .
>
> . . .
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> . . . [T]he committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangible transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. . . .

Id. at 423-25.

The Conference Committee suggested only one change – to broaden the sweep of the amendment so as to encompass domestic related party transactions – in order to better serve the objective of the amendment, "that the division of income between related parties reasonably reflect the relative economic activity undertaken by each . . . ." H.R. Conf. Rep. No. 99-841, at II-637 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4725. It also clarified that cost-sharing arrangements qualify as QCSAs only "if and the extent . . . the income allocated among the parties reasonably reflect the actual economic activity undertaken by each." H.R. Conf. Rep. No. 99-841, at II-638, 1986 U.S.C.C.A.N. at 4726.

C

Treasury's first response to the Tax Reform Act was the "White Paper," an intensive study published in 1988. *A Study of Intercompany Pricing under the Code*, I.R.S. Notice 88-123, 1988-C.B. 458 ("White Paper"). The White Paper makes clear that Treasury initially understood the commensurate with income standard to be consistent with the arm's length standard (and that Treasury understood Congress to share that understanding). *Id.* at 475. Treasury wrote that a comparability analysis must be performed where possible, *id.* at 474, but it also suggested a "clear and convincing evidence" standard for comparables, suggesting that a comparability analysis would rarely suffice, *id.* at 477-78.

Despite its use of the phrase "arm's length standard," the White Paper signaled a dramatic shift from the standard as it had been defined following the 1968 regulations. Treasury advanced a new allocation method, the "basic arm's length return method," *id.* at 488, which – contrary to its name – would apply only in the absence of comparables and would essentially split profits between the related parties, *id.* at 490.[4] The White Paper's re-framing of the arm's length standard was not novel:

> [D]espite the Treasury's affirmation of the traditional [arm's length standard] in its 1988 White Paper, this narrow conception . . . was already obsolete by 1988 in the large majority of cases, insofar as the United States' approach to international taxation was concerned. Subsequent developments, especially the recently issued proposed, temporary and final regulations under section 482 of the Code, merely strengthened the nails in its coffin.

Avi-Yonah, *supra*, at 94-95.

The White Paper was silent regarding employee stock compensation – unsurprisingly, as the practice did not develop on a major scale until the 1990s. Zvi Bodie, Robert S. Kaplan, & Robert C. Merton, *For the Last Time: Stock Options Are an Expense*, 81 Harv. Bus. Rev. 62, March 2003, at 63, 67 (March 2003).

In 1994 and 1995, Treasury issued the regulations challenged in *Xilinx*. As in previous iterations, the 1994-1995 regulations defined the arm's length standard as results-oriented, meaning that the goal is parity in taxable income rather than parity in the method of allocation itself. Treas. Reg. § 1.482-1(b)(1) (1994)

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[4] Contemporary commentators understood that, by attempting synthesis between the arm's length and commensurate with income provisions, Treasury was moving away from a view of the arm's length standard as grounded in comparability. Marc M. Levy, Stanley C. Ruchelman, & William R. Seto, *Transfer Pricing of Intangibles after the Section 482 White Paper*, 71 J. Tax'n 38, 38 (1989); Josh O. Ungerman, Comment, *The White Paper: The Stealth Bomber of the Section 482 Arsenal*, 42 Sw. L.J. 1107, 1128-29 (1989).

("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."). The arm's length standard remained "the standard to be applied in every case." § 1.482-1(b)(1) (1994).

The regulations also set forth methods by which income could be allocated among related parties in a manner consistent with the arm's length standard. § 1.482-1(b)(2)(i) (1994). Absent from the list of approved methods was the method outlined in the singular cost-sharing regulation separately issued in 1995, § 1.482-7. The 1995 regulation provided that intangible development costs included "all of the costs incurred by . . . [an uncontrolled] participant related to the intangible development area." Treas. Reg. § 1.482-7(d)(1) (1995). Beginning in 1997, the Secretary interpreted the "all . . . costs" language to include stock-based compensation, meaning that controlled taxpayers had to share the costs (and associated deductions) of providing employee stock compensation. *Xilinx v. Comm'r*, 598 F.3d 1191, 1193-94 (9th Cir. 2010).

According to Treasury, the 1994 regulations defined the arm's length standard in terms of "the results that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances." Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. 48,997, 48,998 (July 29, 2002). On the other hand, the 1995 regulation, consistent with the 1986 Conference Report excerpted above, "implement[ed] the commensurate with income standard in the context of cost sharing arrangements" by "requir[ing] that controlled participants in a [QCSA] share all costs incurred that are related to the development of intangibles in proportion to their shares of the reasonably anticipated benefits attributable to that development." *Id.* Recognizing the potential for conflict between the 1994 and 1995 regulations (also discussed by this Court in *Xilinx*, as described below), Treasury later issued new cost-sharing regulations, the 2003 regulations that Altera now challenges.

IV

We turn then, to the disputed 2003 amendments to the regulations, which Treasury intended to clarify rather than overhaul the 1994 and 1995 regulations. The clarifications were two-fold. First, the amendments expressly classified employee stock compensation as a cost to be allocated between QCSA participants. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 48,998; Treas. Reg. § 1.482-7A(d)(2). Second, the "coordinating" amendments clarified Treasury's understanding that the cost-sharing regulations, including § 1.482-7A(d)(2), operate to produce an arm's length result. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 49,000; Treas. Reg. § 1.482-7A(a)(3).

Altera challenges two regulations. It squarely challenges 26 C.F.R. § 1.482-7A(d)(2). It also objects to § 1.482-7A(a)(3), but only insofar as it incorporates § 1.482-7A(d)(2) by reference.

Broadly, § 1.482-7A provides that costs are shared by parties to a QCSA, a controlled cost-sharing arrangement that meets the standards of the cost-sharing regulations and thus enables the participants to avoid an IRS adjustment. Section 1.482-7A(a)(3) incorporates and attempts synthesis with the arm's length standard:

> A qualified cost sharing arrangement produces results that are consistent with an arm's length result . . . if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development . . . .

Section 1.482-7A(d)(2) provides that parties to a QCSA must allocate stock-based compensation between themselves:

> [In a QCSA], a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

Altera does not challenge the allocation of other intangible development costs under § 1.482-7A(d).

In determining whether Treasury's regulation is permissible, we are faced with two questions: whether Treasury's "decreed result [is] within the scope of its lawful authority," and whether "the process by which it reache[d] that result [was] logical and rational." *Michigan v. EPA*, 135 S. Ct. 2699, 2706

(2015) (quoting *State Farm*, 463 U.S. at 43). Consideration of these issues requires examination of the APA and *Chevron* deference.

The Tax Court correctly held that the APA applies to Treasury in the context of the present controversy. *See Mayo Found. for Med. Ed. & Res. v. United States*, 562 U.S. 44, 55 (2011) ("In the absence of [any] justification, we are not inclined to carve out an approach to administrative review good for tax law only.").[5]

Under the APA, we must "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," "in excess of statutory jurisdiction," or "without observance of procedure required by law." 5 U.S.C. § 706(2)(A), (C)-(D). However, "[t]he scope of review under the 'arbitrary and capricious' standard is narrow and a court is not to substitute its judgment for that of the agency." *State Farm*, 463 U.S. at 43.

If we conclude that Treasury complied with the APA in its rulemaking, we apply the familiar *Chevron* standard in examining the agency's interpretation of the statute that defines the scope of its authority. *Chevron*, 467 U.S. at 843.

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[5] Because the Commissioner does not contest the applicability of the APA or *Chevron* in this context, this 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. *See generally, e.g.*, Stephanie Hoffer and Christopher J. Walker, *The Death of Tax Court Exceptionalism*, 99 Minn. L. Rev. 221 (2014); Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 Notre Dame L. Rev. 1727 (2007).

A

Accordingly, our first task is to determine whether Treasury complied with the APA in the first instance. Only if Treasury complied with the APA may we defer to its interpretation of § 482 under *Chevron*. *Encino Motorcars*, *LLC v. Navarro*, 136 S.Ct. 2117, 2125 (2016).[6]

The APA "sets forth the full extent of judicial authority to review executive agency action for procedural correctness . . . ." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 513 (2009). It "prescribes a three-step procedure for so-called 'notice-and-comment rulemaking.'" *Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1203 (2015) (citing 5 U.S.C. § 553). First, a "[g]eneral notice of proposed rule making" must ordinarily be published in the Federal Register." 5 U.S.C. § 553(b). Second, provided that "notice [is] required," the agency must "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments . . . ." § 553(c). "An agency must consider and respond to significant comments received during the

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[6] We note that the procedural posture of this case – following enforcement – differs from that of a typical case challenging a regulation under the APA. Generally, strict APA-based challenges arise in the pre-enforcement context, which is less disruptive to the agency and which allows plaintiffs to avoid the six-year statute of limitations applicable to APA-based challenges. *See* 28 U.S.C. § 2401. By contrast, post-enforcement challenges, often brought after the six-year statute of limitations, are rarely brought under the APA, even if the APA proves relevant. Rather, courts are generally called on to address the degree of deference to which the agency is entitled. In these typical post-enforcement challenges, the ultimate question is not whether the agency action was procedurally defective but rather whether it was a permissible exercise of executive authority. The court focuses not on the APA but on the statute as it is implemented by the agency.

period for public comment." *Perez*, 135 S. Ct. at 1203. Third, the agency must incorporate in the final rule "a concise general statement of [its] basis and purpose." § 553(c).

1

Altera does not dispute that Treasury satisfied the first step by giving notice of the 2003 regulations. *Altera*, 145 T.C. at 103. Nor does there appear to be a controversy as to whether Treasury included in the final rule "a concise general statement of [its] basis and purpose." 5 U.S.C. § 553. Rather, Altera argues that the regulations fail on the second step, asserting that although Treasury solicited public comments, it did not adequately consider and respond to those responses, rendering the regulations arbitrary and capricious under *State Farm*. *Altera*, 145 T.C. at 120-31. We disagree.

Section 706 of the APA directs courts to "decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action." 5 U.S.C. § 706 (flush language). Agencies may not act in ways that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). Following *State Farm*, the touchstone of arbitrary and capricious review under the APA is "reasoned decisionmaking." *State Farm*, 463 U.S. at 52. "[T]he 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.'" *Id.* at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)). "[A]gency action is lawful only if it rests 'on a consideration of the relevant factors.'" *Michigan*, 135 S. Ct. at 2706 (quoting *State Farm*, 463 U.S.

at 43). However, courts may not set aside agency action simply because the rulemaking process could have been improved; rather, we must determine whether the agency's "path may reasonably be discerned." *State Farm*, 463 U.S. at 43 (quoting *Bowman Transp. Inc. v. Arkansas-Best Freight Sys*, 419 U.S. 281, 286 (1974)).

Altera argues that Treasury's rulemaking process does not sufficiently support the regulations, which Altera understands to be a significant departure from Treasury's earlier regulations implementing § 482. This argument is premised on: (1) Treasury's rejection of the comments submitted in opposition to the proposed rule, and (2) Altera's claim that Treasury's current litigation position is inconsistent with statements made during the rulemaking process.

"[A]n agency need only respond to 'significant' comments, *i.e.*, those which raise relevant points and which, if adopted, would require a change in the agency's proposed rule." *Am. Mining Congress v. EPA*, 965 F.2d 759, 771 (9th Cir. 1992) (quoting *Home Box Office v. FCC*, 567 F.2d 9, 35 & n.58 (D.C. Cir. 1977)). If the comments to which the agency did not respond would not bear on the agency's "consideration of the relevant factors," the court may not reverse the agency's decision. *Id.*

Treasury published its notice of proposed rulemaking in 2002. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. 48,997. In its notice, Treasury made clear that it was relying on the commensurate with income provision. *Id.* at 48,998. To support its position, Treasury drew from the legislative history of the 1986 amendment, explaining that Congress intended a party to a QCSA to "bear its portion of all research and development costs." *Id.* (quoting H.R. Conf. Rep. No. 99-841, at II-638). It also informed interested parties of its intent to coordinate the new regulations with the arm's length standard, suggesting that it was attempting to synthesize the potentially disparate standards found within § 482 itself. *Id.*; at 48,998, 49,000-01.

Commenters responded by attacking the proposed regulations as inconsistent with the traditional arm's length standard. To support their position, they primarily discussed arm's length agreements in which unrelated parties did not mention employee stock options. They explained that unrelated parties do not share stock compensation costs because it is difficult to value stock-based compensation, and there can be a great deal of expense and risk involved.

In the preamble to the final rule, Treasury dismissed the comments (and, relatedly, the behavior of controlled taxpayers) as irrelevant:

> Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties . . .). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." *See* H.R. Conf. Rep. No. 99-481, at II-638 (1986). . . . [I]n order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must re-

> flect all relevant costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the intangibles pursuant to the QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.
>
> Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances. . . . 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. . . .

Compensatory Stock Options under Section 482 (Preamble to Final Rule), 68 Fed. Reg. 51,171, 51,172-73 (Aug. 26, 2003).

Treasury added:

> Treasury and the IRS believe that if a significant element of [the costs shared by unrelated parties] consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

Id. at 51,173.

With its references to legislative history, Treasury communicated its understanding that Congress had called upon it to move away from the traditional arm's length standard.

In short, the objectors were arguing that the evidence they cited – showing that unrelated parties do not share employee stock compensation costs – proved that Treasury's commensurate with income analysis did not comport with the arm's length standard. Thus, the thrust of the objection was that Treasury misinterpreted § 482. But that is a separate question – one properly addressed in the *Chevron* analysis. That commenters disagreed with Treasury's interpretation of the law does not make the rulemaking process defective.

Under the APA, the issue is whether Treasury's references to legislative history gave interested parties notice of its proposal and an opportunity to respond to it. Here, Treasury's "path may reasonably be discerned." *State Farm*, 463 U.S. at 43. Treasury's citations to legislative history in the notice of proposed rulemaking and the preamble to the final rule make clear enough why Treasury believed it could require related parties to share all costs – including employee stock compensation – in proportion to the income enjoyed by each. Treasury set forth its understanding that it should not examine comparable transactions when they do not in fact exist and should instead focus on a fair and reasonable allocation of costs and income. Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 48,998 (quoting H.R. Conf. Rep. No. 99-841, at II-638); *accord* Compensatory Stock Options under Section 482 (Preamble to Final Rule), 68 Fed. Reg. at 51,172. Treasury relied on Congressional rejection of primacy of the traditional arm's length standard. None of the comments at issue address why Treasury was mistaken in its understanding that it was authorized to use a method that did not include comparables.

Thus, Treasury's refusal to credit oppositional comments is not fatal to a holding that it complied with the APA. Treasury gave sufficient notice of what it intended to do and why; it considered the comments, but it rejected them. Because the comments had no bearing on "relevant factors" to the rulemaking, nor any bearing on the final rule, there was no APA violation. *Am. Mining Congress*, 965 F.2d at 771.

Further, Treasury's current litigation position is not inconsistent with the statements it made to support the 2003 regulations at the time of the rulemaking. Altera argues that its position is justified by *SEC v. Chenery Corp.*, 332 U.S. 194 (1947). "[A] reviewing court . . . must judge the propriety of [agency] action solely by the grounds invoked by the agency." *Chenery*, 332 U.S. at 196. "If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis." *Id.*

Altera argues that the Commissioner cannot now claim that "Treasury reasonably determined that it was statutorily authorized to dispense with comparability analysis" because "[n]owhere in the regulatory history did the Secretary suggest that he 'was statutorily authorized to dispense with comparability analysis.'" This argument twists *Chenery*, which protects judicial deference by strengthening administrative processes, into excessive proceduralism. *See Nat'l Elec. Mfrs. Ass'n v. United States Dept. of Energy*, 654 F.3d 496, 515 (4th Cir. 2011) ("[*Chenery*] does not oblige the agency to provide exhaustive, contemporaneous legal arguments to preemptively defend its action."). But it is also inconsistent with the record, given Treasury's citation to legislative history.

2

Altera also argues that Treasury did not adequately support its position that employee stock compensation is a cost. Treasury cites generally to "tax and other accounting principles" for its determination that there is a "cost associated with stock-based compensation." Compensatory Stock Options Under Section 482 (Proposed), 67 Fed. Reg. at 48,999. Treasury classifies stock compensation as a "critical element" of R&D costs and notes that it is "clearly related to the intangible development area." Compensatory Stock Options under Section 482 (Preamble to Final Rule), 68 Fed. Reg. at 51,173.

The rulemaking record is sufficient to survive an APA challenge because Treasury's position is supported by logic and by industry norms. Treasury wrote that parties would not "ignore" stock-based compensation if such compensation were a "significant element" of the compensation costs one party incurs and another party agrees to reimburse. *Id.* at 51,173. Treasury's determination is reasonable because parties dealing at arm's length certainly would not grant stock options to each other's employees without mentioning the arrangement in the cost-sharing agreement. In other words, parties dealing at arm's length simply do not share these costs, but related parties, whose stock is commonly owned, do. "[T]hrough bargaining," each unrelated party ensures that the cost-sharing agreement is in its best interest, meaning that the parties will consider the internal costs of stock compensation without requiring the other party to recognize those costs. *Id.*

A distinction exists between the economic costs of stock compensation – which are debatable – and the accounting costs – which are not. Because entities account for the cost of providing employee stock options, it is reasonable for Treasury to allocate the costs, and it is irrelevant how much the same entity ultimately pays to provide the options. Further, as the Commissioner noted, "tax and other accounting principles" provide a strong foundation for the Commissioner's interpretation.

Most notably, the Tax Code classifies stock-based compensation as a trade or business "expense." 26 U.S.C. § 162(a). And the challenged regulation cites to the provision providing that the expense is deductible. Treas. Reg. § 1.482-7A(d)(2)(iii)(A) (citing 26 U.S.C. § 83(h)) ("[T]he operating expense attributable to stock-based compensation is equal to the amount allowable . . . as a deduction for Federal income tax purposes . . . (for example, under 83(h)) . . . ."). Indeed, the dispute here is not truly whether stock-based compensation is a cost but whether Altera – rather than the Commissioner – may decide how to apportion that cost between related entities.

3

Finally, in addition to its general *State Farm* argument, Altera asks for a more searching review under *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502. Altera claims that the cost-sharing amendments present a major shift in administrative policy such that Treasury could not issue the regulations without carefully considering and broadcasting its decision. Altera argues that "[t]he assertion that the commensurate with income clause supplants the arm's-length standard with a 'purely internal' analysis is a sharp – but unacknowledged – reversal from Treasury's long-standing prior policy." Red Br. 47.

"Agencies are free to change their existing policies as long as they provide a reasoned explanation for the change." *Encino Motorcars*, 136 S. Ct. at 2125. Indeed, "[w]hen an agency changes its existing position, it 'need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate.'" *Id.* at 2125-26 (quoting *Fox*, 556 U.S. at 515). However, an agency may not "depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." *Fox*, 556 U.S. at 515.

> [A] policy change complies with the APA if the agency:
>
> (1) displays "awareness that it is changing position,"
>
> (2) shows that "the new policy is permissible under the statute,"
>
> (3) "believes" the new policy is better, and
>
> (4) provides "good reasons" for the new policy, which, if the "new policy rests upon factual findings that contradict those which underlay its prior policy," must include "a reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy."

Organized Vill. of Kake v. USDA, 795 F.3d 956, 966 (9th Cir. 2015) (en banc) (ellipses in original) (quoting *Fox*, 556 U.S. at 515-16).

This argument is not meaningfully different from Altera's general APA argument. If the arm's length standard allows the Commissioner to allocate costs between related parties without a comparability analysis, there is no policy change, merely a clarification of the same policy. Moreover, even if the policy changed, it changed well before 2003, as *Xilinx* demonstrates. And if so, it changed as a result of the 1986 amendment to § 482, in which case the question is, again, whether the cost-sharing regulations are allowable under *Chevron*.

4

Thus, the 2003 regulations are not arbitrary and capricious under the standard of review imposed by the APA. Treasury's regulatory path may be reasonably discerned. Treasury understood § 482 to authorize it to employ a purely internal, commensurate with income approach in dealing with related companies. It provided adequate notice of its intent and adequately considered the objections. Its conclusion that stock based compensation should be treated as a cost was adequately supported in the record, and its position did not represent a policy change under *Fox*.

B

Having determined that Treasury adequately satisfied the *State Farm* requirements, we turn to *Chevron*.

1

Under *Chevron*, we first apply the traditional rules of statutory construction to determine whether "Congress has directly spoken to the precise question at issue." *Chevron*, 467 U.S. at 842. We start with the plain statutory words, and "when deciding whether the language is plain, we must read the words 'in their context and with a view to their place in the overall statutory scheme.'" *King v. Burwell*, __ U.S. __, __, 135 S. Ct. 2480, 2489 (2015) (quoting *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000)). In addition, we examine the legislative history, the statutory structure, and "other traditional aids of statutory interpretation" in order to ascertain congressional intent. *Middlesex Cty. Sewerage Auth. v. Nat'l Sea Clammers Ass'n*, 453 U.S. 1, 13 (1981). If, after conducting that *Chevron* step one examination, we conclude that the statute is silent or ambiguous on the issue, we then defer to the agency's interpretation so long as "it is based on a permissible construction of the statute." *Chevron*, 467 U.S. at 843. A permissible construction is one that is not "arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844.

Ultimately, questions of deference boil down to whether "it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority." *United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001). "When Congress has 'explicitly left a gap for an agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,' and any ensuing regulation is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." *Id.* at 227 (internal citation and footnote omitted) (quoting *Chevron*, 467 U.S. at 843-44).

Here, the resolution of our step one *Chevron* examination is straightforward. Section 482 does not speak directly to whether the Commissioner may require parties to a QCSA to share employee stock compensation costs in order to receive the tax benefits associated with entering into a QCSA. Further, as the text of the statute and its legislative history indicate, Congress intended to provide Treasury with the flexibility it needed to prevent improper cost and income allocation between related parties for the purpose of defeating tax liability.

Thus, we must move on to *Chevron* step two to consider whether Treasury's interpretation of § 482 as to allocation of employee stock option costs is permissible. An agency's interpretation of statutory authority is examined "in light of the statute's text, structure and purpose." *Miguel-Miguel v. Gonzales*, 500 F.3d 941, 949 (9th Cir. 2007). The interpretation fails if it is "unmoored from the purposes and concerns" of the underlying statutory regime. *Judulang*, 565 U.S. at 64. Thus, Congress's purpose in enacting and amending § 482 in 1986 is key to resolution of this issue. That purpose is parity. *First Sec. Bank of Utah*, 405 U.S. at 400. The 1986 amendment reflected Congress's recognition that the traditional arm's length standard did not serve the purpose of § 482.

The 1986 amendment to § 482 provides that: "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." This is a purely internal standard, and evidence supports Treasury's belief that Congress intended it to be. H.R. Rep. No. 99-426, at 423-35; H.R. Conf. Rep. No. 99-841, at II-637. Indeed, Congress's objective in amending § 482 was to ensure that income follows economic activity. H.R. Conf. Rep. No. 99-841, at II-637. Further, legislative history supports Treasury's application of the commensurate with income standard in the QCSA context. Congress did not want to interfere with controlled cost-sharing arrangements, but only to the degree that the allocation of costs and income "reasonably reflect[s] the actual economic activity undertaken by each." H.R. Conf. Rep. No. 99-841, at II-638.

Treasury's decision to dispense with a comparability analysis was reasonable.

So was Treasury's determination that uncontrolled cost-sharing arrangements do not provide helpful guidance regarding allocations of employee stock compensation. As discussed above, Treasury discounted the relevance of comments demonstrating that parties at arm's length do not share employee stock compensation costs, writing: "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." Compensatory Stock Options under Section 482 (Preamble to Final Rule), 68 Fed. Reg. at 51,173.

Treasury's conclusion is entirely consistent with Congress's rationale for amending § 482 in the first place. *See id.* (citing H.R. Rep. No. 99-426, at 423-25) ("As recognized in the legislative history of the Tax Reform Act of 1986, there is little if any, public data regarding transactions involving high-profit intangibles."); *see also* H.R. Rep. No. 99-426, at 425 ("There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. . . . [I]t is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation be commensurate with the income attributable to the intangible.").[7]

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[7] Although the 2017 amendment to § 482 has no bearing on our opinion, we note that Congress has not changed its mind:

> The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign

As Congress noted, the goal of parity is not served by a constant search for comparable transactions. H.R. Rep. No. 99-426, at 423. That is why, in 1986, it acted by adding the commensurate with income standard to § 482, synthesizing the long-standing arm's length standard with the new provision; without an internal approach to allocation, related parties had been able to escape paying the taxes that would be paid by parties dealing at arm's length. In other words, the amendment was intended to hone the definition of the arm's length standard so that it could work to achieve arm's length results instead of forcing application of arm's length methods.

Thus, the 2003 regulations are not "arbitrary and capricious in substance." *Mayo Found.*, 562 U.S. at 53 (quoting *Household Credit Servs., Inc. v. Pfennig*, 541 U.S. 232, 242 (2004)). Treasury reasonably understood § 482 as an authorization to require internal allocation methods in the QCSA context, provided that the costs and income allocated are proportionate to

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> company through pricing that does not reflect an arm's length result. . . . The arm's length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties.
>
> . . .
>
> For income from intangible property, section 482 provides 'in the case of any transfer (or license) of intangible property (within the meaning of section 936 (h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.' By requiring inclusion in income of amounts commensurate with the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property – including, in particular, high-profit-potential intangibles.

H. Rep. No. 115-466, at 574-75 (2017)

the economic activity of the related parties. Treasury's interpretation is not "arbitrary, capricious, or manifestly contrary to the statute," and it is therefore permissible under *Chevron*. 467 U.S. at 844.

2

Altera contends that the Commissioner misreads § 482 and its history, arguing that the addition of the commensurate with income standard to § 482 did nothing to change the meaning and operation of the arm's length standard. Altera supports its argument with a canon of construction: "Amendments by implication, like repeals by implication, are not favored." *United States v. Welden*, 377 U.S. 95, 102 n.12 (1964). The canon does not apply here. It operates to prevent courts from attributing unspoken motives to legislators, not to force courts to ignore legislative action. It is illogical to argue that an amendment does not change the meaning of the statute that is amended. Moreover, Altera's conclusion, that the commensurate with income standard is one method of satisfying the arm's length standard, is one with which the Commissioner agrees.

Altera's interpretation of the 1986 amendment would render the commensurate with income clause meaningless except in two circumstances: (1) to allow the Commissioner to periodically adjust prices initially assigned following a comparability analysis; and (2) to reflect a party's contribution of existing intangible property or "buy-in" to a cost-sharing arrangement. This narrow reading of § 482 is not supported by the text or history of the 1986 amendment.

The Commissioner's allocation of employee stock compensation costs between related parties is necessary for Treasury to fulfill its obligation under § 482. Congress did not intend to interfere with qualified cost-sharing arrangements when those arrangements provided for the allocation of income consistent with the commensurate with income provision. H.R. Conf. Rep. No. 99-841, at II-638.

3

Altera makes much of the United States's treaty obligations with other countries. However, there is no evidence that the unworkable empiricism for which Altera argues is also incorporated into our treaty obligations. As demonstrated by nearly a century of interpreting § 482 and its precursor, the arm's length standard is aspirational, not descriptive. It reflects neither how related parties behave nor how they are taxed. Moreover, our most recent treaties incorporate not only the arm's length standard, but also the 2003 regulations. *See, e.g.*, Technical Explanation of the US-Poland Tax Treaty, at 31 (Feb. 13, 2013) ("It is understood that the Code section 482 'commensurate with income' standard for determining appropriate transfer prices for intangibles operates consistently with the arm's-length standard. The implementation of this standard in the regulations under Code section 482 is in accordance with the general principles of paragraph 1 of Article 9 of the Convention . . . .").

The 1986 amendment focused specifically on intangibles, and it gives Treasury the ability to respond to rapid changes in the high tech industry. "The broad language of [§ 482] reflects an intentional effort to confer the flexibility necessary to forestall . . . obsolescence." *Massachusetts v. EPA*, 549 U.S. 497, 532 (2007). In the modern economy, employee stock options are integral to R&D arrangements. In fact, in Altera's 2015 annual report, its stock-based compensation cost equaled nearly five percent of total revenue. Altera Corp., Annual Report for the Fiscal Year

Ended Dec. 31, 2014 (Form 10-K). Simply speaking, the rise in employee stock compensation is an economic development that Treasury cannot ignore without rejecting its obligations under § 482.

4

Altera also argues that the outcome of this case is controlled by our Court's decision in *Xilinx*. We disagree. While the *Xilinx* panel could have reached a holding that would foreclose the Commissioner's current position, it did not.

In *Xilinx*, this Court considered the 1994 and 1995 cost-sharing regulations. The case involved a matter of regulatory interpretation, not executive authority. Xilinx, Inc., another maker of programmable logic devices, challenged the Commissioner's allocation of employee stock options between Xilinx and its Irish subsidiary. 598 F.3d at 1192. As framed by the panel, the issue was whether § 1.482-1 (1994) – which sets forth the arm's length standard – could be reconciled with § 1.482-7(d)(1) (1995) – under which parties to a QCSA were required to share "all . . . costs" incurred in developing intangibles. *Id.* at 1195.

Initially the panel, in a 2-1 decision, voted to reverse the Tax Court, which had unanimously struck the 1995 cost-sharing regulations. *Xilinx, Inc. v. Comm'r*, 567 F.3d 482 (9th Cir. 2009), *withdrawn* 592 F.3d 1017 (9th Cir. 2010). However, the panel withdrew its first opinion after reconsideration, and the panel – over Judge Reinhardt's dissent – ultimately affirmed the Tax Court in striking the regulations. *Xilinx*, 598 F.3d 1191. As framed by all three judges in both the withdrawn and final opinions, the issue came down to whether the arm's length standard and all costs provision could be synthesized. All three judges determined that synthesis was impossible, and the conflict was therefore whether the arm's length standard, versus the all costs provision, had priority.

Xilinx does not control for two reasons. First, the parties in *Xilinx* were not debating administrative authority, and the Court did not consider the "commensurate with income" standard, which Congress itself did not see as inconsistent with the arm's length standard. Second, and more significantly, the *Xilinx* panel was faced with a conflict between two rules. If the rules were conceptually distinguishable, they were also in direct conflict. The arm's length rule, § 1.482-1(b)(1) (1994), listed specific methods for calculating an arm's length result. The all costs provision was not one of those methods, as the first *Xilinx* majority noted. 567 F.3d at 491. Treasury issued the coordinating amendment in 2003, after the tax years at issue in *Xilinx*, and the arm's length regulation now expressly references the cost-sharing provision that Altera challenges. The *Xilinx* panel did not address the "open question" of whether the 2003 regulations remedied the error identified in that decision. 598 F.3d at 1198 n.4 (Fisher, J., concurring). Today, there is no conflict in the regulations, and Altera does not challenge the regulations on the ground that a conflict exists.

V

In sum, we conclude that the Commissioner did not exceed the authority delegated to him by Congress. The Commissioner's rule-making complied with the APA, and its regulation is entitled to *Chevron* deference.

REVERSED.

O'MALLEY, Circuit Judge, dissenting:

A "foundational principle of administrative law [is] that a court may uphold agency action only on the grounds that the agency invoked when it took the action." *Michigan v. EPA*, 135 S. Ct. 2699, 2710 (2015) (citing *SEC v. Chenery Corp.* (*Chenery I*), 318 U.S. 80, 87 (1943)). In promulgating the rule we consider here, Treasury repeatedly insisted that it was applying the traditional arm's length standard and that the resulting rule was consistent with that standard. Today, however, the majority holds that Treasury's citation to the legislative history surrounding the enactment of the Tax Reform Act of 1986 "communicated its understanding that Congress had called upon it to move away from the historical arm's length standard." Op. 31. And the majority finds that, despite Treasury's own statements to the contrary, that same citation to legislative history sufficed to "make it clear enough" to interested parties that Treasury was changing its longstanding practice of applying the arm's length standard in all but the narrowest of circumstances. Op. 32.

The majority, in effect, "suppl[ies] a reasoned basis for the agency's action that the agency itself has not given." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (citing *SEC v. Chenery Corp.* (*Chenery II*), 332 U.S. 194, 196 (1947)). It also endorses a practice of requiring interested parties to engage in a scavenger hunt to understand an agency's rulemaking proposals. That is inconsistent with another fundamental Administrative Procedure Act ("APA") principle: that a notice of proposed rulemaking "should be sufficiently descriptive of the 'subjects and issues involved' so that interested parties may offer informed criticism and comments." *Am.*

Mining Cong. v. U.S. EPA, 965 F.2d 759, 770 (9th Cir. 1991) (quoting *Ethyl Corp. v. EPA*, 541 F.2d 1, 48 (D.C. Cir. 1976) (en banc)). In doing both of these things, the majority stretches "highly deferential" review, *Providence Yakima Med. Ctr. v. Sebelius*, 611 F.3d 1181, 1190 (9th Cir. 2010) (quoting *J & G Sales Ltd. v. Truscott*, 473 F.3d 1043, 1051 (9th Cir. 2007)), beyond its breaking point.

I instead would find, as the Tax Court did, that Treasury's explanation of its rule did not satisfy the *State Farm* standard; that Treasury did not provide adequate notice of its intent to change its longstanding practice of employing the arm's length standard; and that its new rule is invalid as arbitrary and capricious. I would also hold that this court's previous decision in *Xilinx, Inc. v. Commissioner of Internal Revenue* (*Xilinx II*), 598 F.3d 1191 (9th Cir. 2010), controls and mandates an order affirming the Tax Court's decision. I therefore would affirm the judgment of the Tax Court that expenses related to stock-based compensation are not among the costs to be shared in qualified cost sharing arrangements ("QCSAs") under Treas. Reg. § 1.482-7(d)(1) (as amended in 2013). *See Altera Corp. v. Comm'r*, 145 T.C. 91, 92 (2015). For these reasons, I respectfully dissent.

I. Background

A. The Arm's Length Standard

"The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." *Comm'r v. First Sec. Bank of Utah*, 405 U.S. 394, 400 (1972) (quoting Treas. Reg. § 1.482-1(b)(1) (1971)). The "touchstone" of this tax parity inquiry is the arm's length standard. *Xilinx II*, 598 F.3d at 1198 n.1 (Fisher, J., concurring). Since the 1930s, Treasury regulations consistently have explained that, "[i]n 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." Treas. Reg. § 1.482-1(b)(1) (2003). That is, income and deductions are to be allocated among related companies in the same way that unrelated companies negotiating at arm's length would allocate the same income and deductions.

The 1986 amendment that introduced the commensurate with income standard did not dislodge the arm's length test.[1] Congress explained in the committee report that it was introducing the commensurate with income standard to address a "recurrent problem" with transfers of highly valuable intangible property: "the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables." H.R. Rep. No. 99-426, at 423-24 (1985). Congress noted that "[i]ndustry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases," and that "[t]here are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable." *Id.* at 424-25. To address this potential gap, Congress found it "appropriate to require that the payment made on a transfer of intangibles to a related

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[1] This amendment added a second sentence to § 482 that provided: "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." Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562 (codified as amended at 26 U.S.C. § 482).

foreign corporation . . . be commensurate with the income attributable to the intangible." *Id.* at 425.

Treasury reiterated in its 1988 "White Paper" that "intangible income must be allocated on the basis of comparable transactions if comparables exist." *A Study of Intercompany Pricing under Section 482 of the Code* ("White Paper"), I.R.S. Notice 88-123, 1988-2 C.B. 458, 474; *see also id.* at 473 (noting that, where "there is a true comparable for" the licensing of a "high profit potential intangible[]," the royalty rate for the license "must be set on the basis of the comparable because that remains the best measure of how third parties would allocate intangible income"). Only "in situations in which comparables do not exist" would the commensurate with income standard apply. *Id.* at 474. Indeed, the United States continued to insist in tax treaties, and in documents that Treasury issued to explain these treaties, that § 482 reflected the arm's length principle. *See Xilinx*, 598 F.3d at 1196-97 (citing tax treaty explanations); *see also id.* at 1198 n.1 (Fisher, J., concurring) (noting that "the 1997 United States-Ireland Tax Treaty, . . . and others like it, reinforce the arm's length standard as Congress' intended touchstone for § 482").[2]

B. Treatment of Stock-Based Compensation

Treasury promulgated new regulations governing the tax treatment of controlled transactions in 1994

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[2] As the majority observes, more recent tax treaty explanations have also cited the alternative commensurate with income standard. Op. 42-43 (citing Technical Explanation of the US-Poland Tax Treaty, at 31 (Feb. 13, 2013)). Even these explanations, however, emphasize the primacy of the arm's length standard, and they assure the reader that the commensurate with income standard "operates consistently with the arm's-length standard." Technical Explanation of the US-Poland Tax Treaty, at 30-31 (Feb. 13, 2013).

and 1995. These regulations affirmed that "the standard to be applied in every case" was the arm's length standard. Treas. Reg. § 1.482-1(b)(1) (as amended in 1994). They also provided that intangible development costs included "all of the costs incurred by . . . [an uncontrolled] participant related to the intangible development area." Treas. Reg. § 1.482-7(d)(1) (as amended in 1995). The IRS interpreted this latter "all costs" provision to include stock-based compensation, so that related companies in cost-sharing agreements would have to share the costs of providing such compensation. *Xilinx II*, 598 F.3d at 1193-94.

When Xilinx, Inc. ("Xilinx") challenged the IRS's interpretation, the Tax Court decided that the agency's reading violated Treas. Reg. § 1.482-1, because the IRS had not adduced evidence sufficient to show that unrelated parties transacting at arm's length would share expenses related to stock-based compensation. *Xilinx v. Commissioner* (*Xilinx I*), 125 T.C. 37, 53 (2005). The Commissioner did not appeal this underlying factual finding and, instead, argued on appeal to this court that Treas. Reg. § 1.482-7 superseded the arm's length requirement of Treas. Reg. § 1.482-1. All three members of the divided panel therefore assumed that sharing expenses related to stock-based compensation would be inconsistent with the arm's length standard. *Xilinx II*, 598 F.3d at 1194 ("The Commissioner does not dispute the tax court's factual finding that unrelated parties would not share [employee stock options] as a cost."); *id.* at 1199 (Reinhardt, J., dissenting) (assuming that the Tax Court "correctly resolved" the issue of whether sharing stock-based compensation costs would constitute an arm's length result). We also assumed that Treas. Reg. § 1.482-7 required stock-based compensation expenses to be shared. *Id.* at 1196 (majority opinion) (noting that the "all costs" provision "does not permit any exceptions, even for costs that unrelated parties would not share"); *id.* at 1199 (Reinhardt, J., dissenting) (assuming that the "all costs" provision includes "employee stock option costs"). But a majority of the panel ultimately held that the arm's length standard, which was the fundamental "purpose" of the regulations, trumped Treas. Reg. § 1.482-7, and therefore that stock-based compensation expenses could not be shared in the absence of evidence that unrelated parties would share such costs. *Id.* at 1196 (majority opinion); *see also id.* at 1198 n.1 (Fisher, J., concurring) (finding "the arm's length standard" to be "Congress' intended touchstone for § 482"). On that ground, we affirmed the Tax Court's judgment in favor of Xilinx. *Id.* at 1196 (majority opinion).

C. The Regulation at Issue

While *Xilinx II* was pending before this court, Treasury promulgated the regulations at issue here. Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,172 (Aug. 26, 2003) (codified at 26 C.F.R. pts. 1 and 602). The amended regulations sought to reconcile the apparent contradiction between the arm's length standard in Treas. Reg. § 1.482-1 and the requirement that stock-based compensation expenses be shared under Treas. Reg. § 1.482-7. The former provision now specifies that § 1.482-7 "provides the specific method to be used to evaluate whether a [QCSA] produces results consistent with an arm's length result." Treas. Reg. § 1.482-1(b)(2)(i) (2003). And § 1.482-7, in turn, now provides that a QCSA produces an arm's length result "if, and only if," the participants share all of the costs of intangible development – explicitly including costs associated with stock-based compensation – in proportion to their shares of reasonably anticipated benefits attributable to such development. Treas. Reg. § 1.482-7(d)(2) (2003).

Altera Corp. ("Altera U.S."), a Delaware corporation, and its subsidiary Altera International, a Cayman Islands corporation, (collectively, "Altera") entered into several cost-sharing agreements in 1997, under which Altera U.S. licensed various forms of intangible property to Altera International, and Altera International paid royalties to Altera U.S. *Altera*, 145 T.C. at 92-93. During the 2004 to 2007 taxable years, Altera U.S. granted stock options and other stock-based compensation to certain of its employees, but costs related to that compensation were not included in the cost pool under the operative cost-sharing agreements. *Id.* at 93.

Each year from 2004 to 2007, the IRS notified Altera that the cost-sharing payments did not satisfy the new regulations. *Id.* at 94. But when Altera challenged these regulations, the Tax Court unanimously held, as discussed in more detail below, that the explanation Treasury offered in the preamble accompanying the new regulations was insufficient to justify those regulations under State Farm. *Id.* at 120-33. The Commissioner appeals that decision.

II. Discussion

The Tax Court considered and rejected Treasury's stated explanation for its regulation – that Treasury applied the commensurate with income test because it could find no transactions comparable to the QCSAs at issue, and that Treasury's analysis was actually consistent with the arm's length standard. But the Commissioner now argues on appeal, and the majority accepts, that what Treasury was *actually* saying is that § 482 no longer requires an arm's length analysis. I disagree.

A. The New Rule Is Invalid Under *State Farm*

Under the Administrative Procedure Act, we must "hold unlawful and set aside agency action . . . found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2). To satisfy this standard, "the 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.'" *State Farm*, 463 U.S. at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)). "That is, an agency must 'cogently explain why it has exercised its discretion in a given manner,' and '[i]n reviewing that explanation, we must "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment."'" *Nw. Envtl. Def. Ctr. v. Bonneville Power Admin.*, 477 F.3d 668, 687 (9th Cir. 2007) (alteration in original) (quoting *State Farm*, 463 U.S. at 43, 48).

Although an agency action is not subject to "more searching review" simply because it represents a change in position, "the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it *is* changing position." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 514-15 (2009). "An agency may not, for example, depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." *Id.* And an agency may need to "provide a more detailed justification than what would suffice for a new policy created on a blank slate . . . when, for example, . . . its prior policy has engendered serious reliance interests that must be taken into account." *Id.* (citing *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 742 (1996)). "'Unexplained inconsistency' between agency actions is 'a reason for holding an interpretation to be an arbitrary and capricious change.'" *Organized Vill. of Kake v. USDA*, 795 F.3d 956, 966 (9th Cir. 2015) (en banc) (quoting *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005)).

Our review of an agency regulation is "highly deferential, presuming the agency action to be valid and affirming the agency action if a reasonable basis exists for its decision." *Crickon v. Thomas*, 579 F.3d 978, 982 (9th Cir. 2009) (quoting *Nw. Ecosystem All. v. U.S. Fish & Wildlife Serv.*, 475 F.3d 1136, 1140 (9th Cir. 2007)). But "an agency's action must be upheld, if at all, on the basis articulated by the agency itself." *State Farm*, 463 U.S. at 50 (citing *Burlington Truck Lines*, 371 U.S. at 168). For that reason, "we may not supply a reasoned basis for the agency's action that the agency itself has not given." *Id.* at 43 (citing *Chenery II*, 332 U.S. at 196).

I start, therefore, with what Treasury said when it promulgated the regulation at issue. In Treasury's notice of proposed rulemaking, the agency explained the origins of the commensurate with income standard and discussed the White Paper. Compensatory Stock Options Under Section 482, 67 Fed. Reg. 48,997, 48,998 (proposed July 29, 2002) (to be codified at 26 C.F.R. pt. 1). Treasury noted, in particular, the White Paper's observation "that Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm's length standard." *Id.* (citing White Paper, 1988-2 C.B. at 458, 477). Treasury then detailed how the proposed rules would function, including that the new rules required stock-based compensation costs to be included among the costs shared in a QCSA to produce "results consistent with an arm's length result." *Id.* at 49,000-01.

Treasury expanded on its reasoning in the preamble to the final rule. It explained that the tax treatment of stock-based compensation in QCSAs would have to be consistent "with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines)." Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,172. Treasury observed, however, that the legislative history of the 1986 amendment to § 482 "expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that participants' shares of income 'reasonably reflect the actual economic activity undertaken by each.'" *Id.* (quoting H.R. Conf. Rep. No. 99-481, at II-638 (1986)). Applying this standard, Treasury declared that, "in order for a QCSA to reach an arm's length result consistent with legislative intent," the QCSA must include stock-based compensation among the costs shared. *Id.*

Throughout the preamble, Treasury repeatedly emphasized that it was applying the arm's length standard. Treasury explained, for example, that "[t]he regulations relating to QCSAs *have as their focus* reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles." *Id.* (emphasis added). Treasury determined that "[p]arties *dealing at arm's length* in [a cost-sharing] arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation." *Id.* (emphasis added). And Treasury concluded that "[t]he final regulations provide that stock-based compensation must be taken into account in the context of QCSAs *because* such a result is consistent with the arm's length standard." *Id.* (emphasis added).

Treasury also responded to comments invoking the arm's length standard. *See id.* (rejecting "comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances"). Treasury acknowledged that comparable arm's-length transactions may have been relevant, but it determined that there were no comparable transactions available for QCSAs for the development of high-profit intangibles:

> While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. 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.

Id. at 51,172-73. Treasury further detailed why it believed that certain comparable transactions proposed by commentators were not in fact comparable. *Id.* at 51,173.

The Tax Court held that Treasury's explanation for its regulation was insufficient under *State Farm*. *Altera*, 145 T.C. at 120-33. It found that Treasury "failed to provide a reasoned basis" for its "belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs." *Id.* at 123. The court acknowledged that agencies need not gather empirical evidence for *some* policy-based propositions, but it held that "the belief that unrelated parties would share stock-based compensation costs in the context of a QCSA" was not such a proposition. *Id.* In reaching this conclusion, the court observed that commentators submitted significant evidence about whether unrelated parties would share stock-based compensation costs in QCSAs; that the Tax Court itself had made a factual determination on that issue in *Xilinx I*; and that Treasury was required at least to attempt to gather empirical evidence before declaring that no such evidence was available. *Id.* at 123-24.

The Tax Court then detailed why Treasury's explanation for the regulations was insufficient. The court noted that only some QCSAs involved high-profit intangibles or included stock-based compensation as a significant element of compensation, yet Treasury failed to distinguish between QCSAs with and without those characteristics. *Id.* at 125-27. And the court found that Treasury responded only in conclusory fashion to a number of comments identifying comparable transactions or explaining why unrelated parties would not share stock-based compensation costs in QCSAs. *Id.* at 127-30. On these grounds, the Tax Court struck down the regulation. *Id.* at 133-34.

The Commissioner does not meaningfully dispute the Tax Court's determination that Treasury's analysis under the arm's length standard was inadequate and unsupported. The Commissioner now contends, instead, "that, in the context of a QCSA, the arm's-length standard does *not* require an analysis of what unrelated entities do under comparable circumstances." Appellant's Br. 57 (internal quotation marks omitted). In the Commissioner's view, Treasury's detailed explanations regarding its comparability analysis were merely "extraneous observations" – "since Treasury reasonably determined that it was statutorily authorized to dispense with comparability analysis in this narrow context, there was no need for it to establish that the uncontrolled transactions cited by commentators were insufficiently comparable." Appellant's Br. 64.

The majority accepts Treasury's rationalization. "With its references to legislative history," the majority holds, Treasury adequately "communicated its understanding that Congress had called upon it to move away from the historical arm's length standard." Op. 31. The majority finds that Treasury was therefore entitled to ignore the comments opposing the final rule because they did not "bear on the agency's 'consideration of the relevant factors.'" Op. 28-29 (quoting *Am. Mining Congress v. EPA*, 965 F.2d 759, 771 (9th Cir. 1992)). As to Altera's rejoinder that Treasury never suggested that it had the authority to "dispense with" comparability analysis entirely, Appellee's Br. 43, the majority dismisses these arguments as "twist[ing] *Chenery* . . . into excessive proceduralism," Op. 33.

I do not share the majority's view. Treasury may well have believed that, given the fundamental characteristics of stock-based compensation in QCSAs, it could dispense with arm's length analysis entirely. *Cf. Xilinx II*, 598 F.3d at 1197 (Fisher, J., concurring) (hypothesizing why unrelated companies may not share stock-based compensation costs). But the APA required Treasury to *say* that it was taking this position, which departed starkly from Treasury's previous regulations. *See Fox*, 556 U.S. at 515 ("[T]he requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it *is* changing position."). As we held in *Xilinx*, the previous regulations preserved the primacy of the arm's length standard and its requirement of comparability analysis. *See Xilinx II*, 598 F.3d at 1195-96 (explaining the then-operative version of Treas. Reg. § 1.482-1).

In amending those regulations, however, Treasury never said – either in the notice of proposed rulemaking or in the preamble accompanying the final rule – that the nature of stock compensation in the QCSA context rendered arm's length analysis irrelevant. Treasury instead explained only that it could not conduct an arm's length analysis because comparable transactions could not be found. *See* Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,172-73 ("While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available."). As the majority acknowledges, in fact, "Treasury set forth its understanding that it should not examine comparable transactions *when they do not in fact exist* and should instead focus on a fair and reasonable allocation of costs and income." Op. 32 (emphasis added).

Treasury itself explained, in effect, that a precondition for the applicability of the commensurate with income standard is the lack of real-world comparable transactions with which to make an arm's-length comparison. The comments submitted were relevant to the issue of whether "similar transactions under similar circumstances" existed. Any such transactions, as Treasury originally admitted, would "ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard." Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,172.[3] If Treasury felt that these comments were irrelevant, it presumably would have said so. Treasury's decision to respond to the comments on their merits underscores that Treasury's only justification for eschewing comparability analysis was its belief that no comparable transactions could be found. The fact that evidence of comparable transactions might support more favorable tax treatment does not mean such comparables do not exist.[4]

The APA's safeguards ensure that those regulated do not have to guess at the regulator's reasoning; just as importantly, they afford regulated parties a meaningful opportunity to respond to that reasoning. Treasury's notice of proposed rulemaking ran afoul of these safeguards by failing to put the relevant public on notice of its intention to depart from traditional arm's length analysis. *See CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1080 (D.C. Cir. 2009)

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[3] The majority points to no language in the notice of proposed rulemaking that contradicts this understanding.

[4] The majority also glosses over the Tax Court's criticism that the final rule applied to all QCSAs, but was based only on Treasury's beliefs about the subset of QCSAs involving "high-profit intangibles" where stock-based compensation is a "significant element" of compensation. *Altera*, 145 T.C. at 125-26 (quoting Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,173). Treasury's failure to explain this leap and the Commissioner's failure to defend it provide another reason that the regulation does not satisfy the *State Farm* standard.

(holding that a final rule "violates the APA's notice requirement where 'interested parties would have had to "divine [the agency's] unspoken thoughts"'" (alteration in original) (quoting *Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 407 F.3d 1250, 1259-60 (D.C. Cir. 2005))). And asking Treasury to show its work in the preamble to its final rule – that is, to set forth when and why the agency believed that arm's length analysis was not required – is not, as the majority suggests, "excessive proceduralism." Op. 33. It is the essence of the review that *State Farm* demands.

When the Tax Court conducted that review, it considered the explanation that Treasury offered, and it found that Treasury "failed to provide a reasoned basis" for its "belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs." *Altera*, 145 T.C. at 123. The Tax Court set forth in detail why Treasury's explanation for the regulations was insufficient. *Id.* at 125-30. Treasury offers no response to these findings; it simply invites this court to recreate the record in order to justify its decisionmaking. I therefore would hold, as the Tax Court did, that the 2003 regulations are invalid under *State Farm*.

B. Section 482 Does Not Require Sharing of Stock-Based Compensation Costs

Because I would find the 2003 regulations were invalid, I believe that this court's decision in *Xilinx II* controls, and that the Tax Court properly entered judgment in favor of Altera. *Altera*, 145 T.C. at 134. Even if *Xilinx II* did not control, I would hold that related parties in QCSAs need not share costs associated with stock-based compensation. "*Chevron* deference is not warranted where the regulation is 'procedurally defective' – that is, where the agency errs by failing to follow the correct procedures in issuing the regulation." *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016) (quoting *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001)). I therefore would interpret the statute in the first instance, without deference.

I agree with the majority that § 482 does not address this issue directly. Op. 38-39. But I agree with *amicus curiae* Cisco Systems, Inc. ("Cisco"), that, under the best reading of § 482, QCSAs are not subject to the commensurate with income standard. *See generally* Amicus Curiae Br. Supporting Appellee and Affirmance on Behalf of Cisco Systems, Inc. As Cisco points out, the commensurate with income standard applies only to a "transfer (or license) of intangible property," 26 U.S.C. § 482, which is distinct from a cost sharing agreement for joint development of intangibles. *See* White Paper, 1988-2 C.B. at 474 (noting that "bona fide research and development cost sharing arrangements" provided a way to "avoid[] section 482 transfer pricing issues related to the licensing or other transfer of intangibles").

QCSAs fall neatly into the latter category. *See* Treas. Reg. § 1.482-7(a)(1) (2003) (defining a QCSA as "an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits"). The Commissioner's argument that the commensurate with income standard applies to "intangible transactions in general, and cost sharing arrangements in particular," Appellant's Br. 57, is inconsistent with the plain language of the statute. Under the only reasonable interpretation of § 482, therefore, the commensurate with income standard does not apply to QCSAs. For at least this reason, I also disagree with the majority's conclusion that Treasury's reading of § 482 satisfies the second step of the *Chevron* test. Op. 39-46.

APPENDIX H

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Altera Corporation & Subsidiaries, *Petitioner-Appellee*, v. Commissioner of Internal Revenue, *Respondent-Appellant*.	Nos. 16-70496 16-70497 Tax Ct. Nos. 6253-12 9963-12 ORDER

Filed August 7, 2018

Before: Sidney R. Thomas, Chief Judge, and Susan P. Graber and Kathleen M. O'Malley* Circuit Judges.

ORDER

The Opinions filed July 24, 2018, are hereby withdrawn to allow time for the reconstituted panel to confer on this appeal.

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* The Honorable Kathleen M. O'Malley, United States Circuit Judge for the U.S. Court of Appeals for the Federal Circuit, sitting by designation.

APPENDIX I

Companies Reporting the *Altera* Issue in SEC Filings

The following public companies noted the *Altera* issue in their quarterly (Forms 10-Q) or annual (Forms 10-K) reports filed with the SEC.*

1. A10 Networks, Inc., Form 10-Q at 61 (Nov. 1, 2019) (headquartered in California)
2. Acacia Communications, Inc., Form 10-Q at 21 (Oct. 30, 2019) (headquartered in Massachusetts) (reporting $6.3 million at stake)
3. Agilent Technologies Inc., Form 10-K at 38 (Dec. 21, 2017) (headquartered in California)
4. Alpha & Omega Semiconductor, Form 10-Q at 23 (Nov. 12, 2019) (headquartered in Bermuda)
5. Alphabet, Inc., Form 10-K at 78 (Feb. 3, 2017) (headquartered in California) (reporting $4.4 billion at stake)
6. Alteryx, Inc., Form 10-Q at 17 (Nov. 8, 2018) (headquartered in California)
7. Ambarella Inc., Form 10-Q at 23 (Dec. 6, 2019) (headquartered in California)
8. Anaplan, Inc., Form 10-Q at 54 (Dec. 9, 2019) (headquartered in California)

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* The list was generated by searching Lexis Securities Mosaic, a commercial database of public company filings, for all Forms 10-Q and 10-K filed between 2015 and the present that mention the opinions in this case issued by the Tax Court or the Ninth Circuit.

9. Apple Inc., Form 10-K at 28 (Nov. 5, 2018) (headquartered in California)
10. Arista Networks, Inc., Form 10-Q at 23 (Nov. 1, 2019) (headquartered in California) (reporting $9.8 million at stake)
11. Cavium, Inc., Form 10-K at 79 (Mar. 1, 2018) (headquartered in California)
12. Cirrus Logic, Inc., Form 10-Q at 17 (Jan. 29, 2020) (headquartered in Texas)
13. Citrix Systems Inc., Form 10-Q at 29 (Nov. 1, 2019) (headquartered in California)
14. Cypress Semiconductor Corp., Form 10-K at 42 (Feb. 26, 2018) (headquartered in California)
15. Dropbox, Inc., Form 10-Q at 74 (Nov. 8, 2019) (headquartered in California)
16. Ebay Inc., Form 10-K at 42-43 (Jan. 31, 2020) (headquartered in California)
17. Elastic N.V., Form 10-Q at 63 (Dec. 9, 2019) (headquartered in California)
18. Electronic Arts, Form 10-Q at 20 (Nov. 6, 2019) (headquartered in California)
19. Electronics for Imaging Inc., Form 10-K at 53 (Feb. 27, 2019) (headquartered in California)
20. EMC Corp., Form 10-K at 23 (Feb. 25, 2016) (headquartered in Massachusetts)
21. Facebook Inc., Form 10-K at 59 (Jan. 30, 2020) (headquartered in California) (reporting $1.1 billion at stake)
22. Fairchild Semiconductor International Inc., Form 10-K at 37 (Aug. 18, 2016) (headquartered in California)

23. Fitbit Inc., Form 10-Q at 27 (Nov. 7, 2019) (headquartered in California)
24. Forrester Research, Inc., Form 10-K at 22 (Mar. 9, 2018) (headquartered in Massachusetts) (reporting $0.6 million at stake)
25. Fortinet, Inc., Form 10-Q at 22 (Oct. 31, 2019) (headquartered in California) (reporting $10.3 million at stake)
26. Gilead Sciences Inc., Form 10-Q at 27 (Nov. 5, 2019) (headquartered in California)
27. Groupon, Inc., Form 10-Q at 22 (Nov. 4, 2019) (headquartered in Illinois) (reporting $14 million at stake)
28. Harmonic Inc., Form 10-Q at 28 (Nov. 4, 2019) (headquartered in California)
29. Hortonworks, Inc., Form 10-Q at 22 (Nov. 8, 2018) (headquartered in California)
30. Immersion Corp., Form 10-Q at 18 (Nov. 7, 2019) (headquartered in California)
31. Integrated Device Technology Inc., Form 10-K at 32 (May 18, 2018) (headquartered in California)
32. Intel Corp., Form 10-K at 89 (Jan. 24, 2020) (headquartered in California)
33. InvenSense Inc., Form 10-Q at 26 (Feb. 2, 2017) (headquartered in California)
34. Ixia, Form 10-Q at 19 (Nov. 7, 2016) (headquartered in California)
35. Juniper Networks Inc., Form 10-K at 37 (Feb. 19, 2016) (headquartered in California) (reporting $13.2 million at stake)
36. Keysight Technologies, Inc., Form 10-Q at 27 (Sept. 2, 2016) (headquartered in California)

37. LAM Research Corp., Form 10-K at 37 (Aug. 20, 2019) (headquartered in California) (reporting $75 million at stake)
38. LinkedIn Corp., Form 10-K at 112 (Feb. 12, 2016) (headquartered in California)
39. Lumentum Holdings Inc., Form 10-Q at 37 (May 7, 2019) (headquartered in California)
40. McKesson Corp., Form 10-K at 94 (May 24, 2018) (headquartered in California) (reporting $25 million at stake)
41. Mentor Graphics Corp., Form 10-Q at 29 (Dec. 6, 2016) (headquartered in Oregon)
42. Microchip Technology Inc., Form 10-Q at 24 (Nov. 7, 2018) (headquartered in Arizona)
43. Microsoft Corp., Form 10-K at 41 (July 28, 2016) (headquartered in Washington)
44. Monolithic Power Systems Inc., Form 10-Q at 21 (Nov. 1, 2019) (headquartered in Washington)
45. Natus Medical Inc., Form 10-Q at 14 (Aug. 8, 2018) (headquartered in California)
46. NetApp, Inc., Form 10-K at 80 (June 22, 2016) (headquartered in California)
47. Norton LifeLock Inc., Form 10-Q at 23 (Feb. 7, 2020) (headquartered in Arizona) (reporting $62 million at stake)
48. Nutanix, Inc., Form 10-Q at 69 (Dec. 5, 2019) (headquartered in California)
49. Nuvasive Inc., Form 10-Q at 26 (July 31, 2018) (headquartered in California)
50. Nvidia Corp., Form 10-Q at 18 (Aug. 19, 2015) (headquartered in California)

51. Oracle Corp., Form 10-Q at 26 (Mar. 18, 2019) (headquartered in California)
52. PayPal Holdings, Inc., Form 10-K at 112 (Feb. 6, 2020) (headquartered in California)
53. Pintrest, Inc., Form 10-Q at 19 (Nov. 1, 2019) (headquartered in California) (reporting $24.9 million at stake)
54. Plantronics Inc., Form 10-Q at 14 (Feb. 6, 2020) (headquartered in California) (reporting $8.6 million at stake)
55. Polycom Inc., Form 10-Q at 26 (Aug. 4, 2016) (headquartered in California)
56. Power Integrations Inc., Form 10-K at 57 (Feb. 7, 2020) (headquartered in California)
57. PTC Inc., Form 10-K at 32 (Nov. 18, 2019) (headquartered in Massachusetts)
58. Qlogic Corp., Form 10-Q at 17 (Aug. 8, 2016) (headquartered in California)
59. Rackspace Hosting, Inc., Form 10-Q at 14 (Nov. 9, 2016) (headquartered in Texas)
60. Sabre Corp., Form 10-Q at 12 (Oct. 30, 2018) (headquartered in Texas)
61. Salesforce Com Inc., Form 10-Q at 36 (Nov. 28, 2018) (headquartered in California) (reporting $30.4 million at stake)
62. Silicon Laboratories Inc., Form 10-K at 32 (Jan. 29, 2020) (headquartered in Texas) (reporting $27.2 million at stake)
63. Skechers USA Inc., Form 10-Q at 21 (Nov. 8, 2019) (headquartered in California) (reporting $1.5 million at stake)
64. Slack Technologies, Inc., Form 10-Q at 19 (Dec. 4, 2019) (headquartered in California)

65. Snap Inc., Form 10-K at 96 (Feb. 5, 2020) (headquartered in California)
66. SolarWinds Corp., Form 10-Q at 21 (Nov. 7, 2019) (headquartered in Texas)
67. Stitch Fix, Inc., Form 10-Q at 39 (June 6, 2019) (headquartered in California)
68. Sunpower Corp., Form 10-Q at 49 (Oct. 31, 2019) (headquartered in California)
69. Synaptics Inc., Form 10-Q at 21 (Feb. 6, 2020) (headquartered in California)
70. Synopsys Inc., Form 10-K at 85 (Dec. 20, 2019) (headquartered in California) (reporting $18.3 million at stake)
71. Tableau Software Inc., Form 10-K at 102 (Feb. 22, 2019) (headquartered in Washington)
72. Take Two Interactive Software Inc., Form 10-Q at 19 (Feb. 7, 2020) (headquartered in New York)
73. Teradata Corp., Form 10-Q at 16 (Nov. 12, 2019) (headquartered in California) (reporting $4 million at stake)
74. Teradyne, Inc., Form 10-Q at 30 (Nov. 8, 2019) (headquartered in Massachusetts) (reporting $5-11 million at stake)
75. Tesla, Inc., Form 10-Q at 14 (Oct. 29, 2019) (headquartered in California)
76. TripAdvisor, Inc., Form 10-Q at 26-27 (Nov. 6, 2019) (headquartered in Massachusetts) (reporting $15 million at stake)
77. Twitter, Inc., Form 10-Q at 25 (Oct. 30, 2019) (headquartered in California) (reporting $80 million at stake)

78. Ubiquiti Inc., Form 10-K at 73 (Aug. 21, 2019) (headquartered in New York)
79. Workday, Inc., Form 10-K at 76 (Mar. 18, 2019) (headquartered in California)
80. Xilinx, Inc., Form 10-Q at 22 (Jan. 28, 2020) (headquartered in California) (reporting $55-60 million at stake)
81. Yahoo Inc., Form 10-K at 63 (Feb. 29, 2016) (headquartered in California)
82. Zynga Inc., Form 10-Q at 57 (Oct. 31, 2019) (headquartered in California)

APPENDIX J

United States Tax Treaties Incorporating the Arm's-Length Standard

The following United States tax treaties contain a provision that allows the signatories to adjust the income of related parties that operate in both countries to reflect what the parties' incomes would have been had they been unrelated companies.*

1. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Aus., Aug. 6, 1982
2. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Austria, May 31, 1996
3. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Bangl., Sept. 26, 2004
4. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Barb., Dec. 31, 1984
5. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Belg., Nov. 27, 2006

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* The list was generated from the list of U.S. tax treaties on the IRS's website. See IRS, *United States Income Tax Treaties – A to Z* (last updated Jan. 8, 2020), https://perma.cc/24AF-LF9W.

6. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9. U.S.-Bulg., Feb. 23, 2007
7. Convention with Respect to Taxes on Income and Capital, art. 9, U.S.-Can., Sept. 26, 1980
8. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 8, U.S.-China, Apr. 30, 1984
9. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 11, U.S.-Cyprus, Mar. 19, 1984
10. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Czech, Sept. 16, 1993
11. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Den., Aug. 19, 1999
12. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 10, U.S.-Egypt, Aug. 24, 1980
13. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Estonia, Jan. 15, 1998
14. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, art. 9, U.S.-Fin., Sept. 21, 1989

15. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 9, U.S.-Fr., Aug. 31, 1994
16. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, art. 9, U.S.-Ger., Aug. 29, 1989
17. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. IV, U.S.-Greece, Feb. 20, 1950
18. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Notes of Exchange, ¶ 3, U.S.-Hung., Feb. 12, 1979
19. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Ice., Oct. 23, 2007
20. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-India, Sept. 12, 1989
21. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 10, U.S.-Indon., July 11, 1988
22. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. 9, U.S.-Ir., July 28, 1997

23. Convention with Respect to Taxes on Income, art. 11, U.S.-Isr., Nov. 20, 1975
24. Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, art. 9, U.S.-It., Aug. 25, 1999
25. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Jam., May 21, 1980
26. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Japan, Nov. 6, 2003
27. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 7, U.S.-Kaz., Oct. 24, 1993
28. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Lat., Jan. 15, 1998
29. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Lith., Jan. 15, 1998
30. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 9, U.S.-Lux., Apr. 3, 1996
31. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Malta, Aug. 8, 2008

32. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Mex., Sept. 18, 1992
33. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Morocco, Aug. 1, 1977
34. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Neth., Dec. 18, 1992
35. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-N.Z., July 23, 1982
36. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Property, art. 7, U.S.-Nor., Dec 3, 1971
37. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. IV, U.S.-Pak., July 1, 1957
38. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 10, U.S.-Phil., Nov. 24, 1976
39. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 10, U.S.-Pol., Oct. 8, 1974

40. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Port., Sept. 6, 1994
41. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Rom., Dec. 4, 1973
42. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 7, U.S.-Russ., June 17, 1992
43. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 9, U.S.-Slovk., Oct. 8, 1993
44. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 9, U.S.-Slovn., June 21, 1993
45. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. 9, U.S.-S. Afr., Feb. 17, 1997
46. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Encouragement of International Trade and Investment, art. 11, U.S.-S. Kor., June 4, 1976
47. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Spain, Feb. 22, 1990

48. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Sri Lanka, Mar. 14, 1985
49. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Swe., Sept. 1, 1994
50. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Switz., Oct. 2, 1996
51. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Thai., Nov. 26, 1996
52. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Encouragement of International Trade and Investment, art. 11, U.S.-Trin. & Tobago, Jan. 9, 1970
53. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Tunis., June 17, 1985
54. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 9, U.S.-Turk., Mar. 28, 1996
55. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 9, U.S.-Ukr., Mar. 4, 1994

56. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. 9, U.S.-U.K., July 24, 2001
57. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 9, U.S.-Venez., Jan. 25, 1999