No. 19-1009

In the Supreme Court of the United States

ALTERA CORPORATION & SUBSIDIARIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Businesses controlled by common interests, such as parent and subsidiary corporations, have an incentive to manipulate the pricing of their internal transactions in order to minimize tax obligations. Under 26 U.S.C. 482, the Secretary of the Treasury may reallocate the "gross income, deductions, credits, or allowances between or among such * * * businesses," if he determines that reallocation is necessary "to prevent evasion of taxes or clearly to reflect the income of any of such * * * businesses." Section 482 further provides that, "[i]n the case of any transfer (or license) of intangible property" between controlled businesses, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." *Ibid.*

Regulations issued by the Department of the Treasury specify when reallocation under Section 482 will occur if controlled companies enter into agreements to share the costs of developing intangible property. The regulations generally require that each controlled company must assume a share of development costs in proportion to that company's reasonably anticipated benefits from the arrangement. In 2003, the Treasury Department promulgated a final rule to clarify that stock-based employee compensation, like other forms of compensation, must be taken into account in determining development costs for these purposes. 68 Fed. Reg. 51,171, 51,177-51,179 (Aug. 26, 2003); see 26 C.F.R. 1.482-7(d)(2) (2004). The question presented is as follows:

Whether the court of appeals correctly held that the Treasury Department's 2003 final rule was not arbitrary or capricious under the Administrative Procedure Act, 5 U.S.C. 551 *et seq.*

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-78a) is reported at 926 F.3d 1061. A prior opinion of the court of appeals (Pet. App. 262a-322a) is not published in the Federal Reporter but is available at 2018 WL 3542989. An order of the court of appeals withdrawing the prior opinion (Pet. App. 323a) is reported at 898 F.3d 1266. The opinion of the Tax Court (Pet. App. 79a-139a) is reported at 145 T.C. 91.

JURISDICTION

The judgment of the court of appeals was entered on June 7, 2019. A petition for rehearing was denied on November 12, 2019 (Pet. App. 140a-167a). The petition for a writ of certiorari was filed on February 10, 2020. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. Businesses under common control, such as parent and subsidiary corporations, have an incentive to manipulate the pricing of their internal transactions in order to minimize taxes—for example, by understating the price at which the U.S. parent company licenses intellectual property to a foreign subsidiary. "[M]ultinational corporations with foreign subsidiaries" sometimes attempt to use such controlled-party transactions to evade U.S. taxes. Pet. App. 7a.

In 1928, Congress first authorized the Secretary of the Treasury to "reallocate the reported income and costs of related businesses," in order to address tax evasion and to ensure that income is accurately reported. Pet. App. 7a; see Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806. The substance of that provision is now codified as the first sentence of Section 482 of the Internal Revenue Code:

> 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.

26 U.S.C. 482.

In 1935, the Department of the Treasury (Treasury) promulgated an implementing regulation that adopted the so-called "arm's length" standard for determining

whether the results of a transaction between entities under common control accurately reflect the income of each party: "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). The arm's-length standard continues to be applied "in every case." 26 C.F.R. 1.482-1(b)(1) ("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."). But the agency's precise methodology for applying the arm's-length standard has varied significantly over time.

For many years, the regulations did not provide any detailed rules for applying the arm's-length standard, and the federal courts adopted a variety of approaches. See *Frank* v. *International Canadian Corp.*, 308 F.2d 520, 528-529 & nn.8-14 (9th Cir. 1962); Pet. App. 9a-10a. During the legislative process leading to the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, Members of Congress expressed dissatisfaction with that lack of clarity. See, *e.g.*, H.R. Rep. No. 1447, 87th Cong., 2d Sess. 28-30 (1962). Congress did not amend Section 482 at that time, but legislators encouraged Treasury to "provide additional guidelines" by regulation. H.R. Conf. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962).

In 1968, Treasury adopted a regulation that, for the first time, called for the examination of "comparable" transactions between uncontrolled parties. 33 Fed. Reg. 5848, 5854 (Apr. 16, 1968). For controlled-party transactions involving intangible property—which raise acute concerns, given the distinctive nature of intangible property and the difficulty of valuing it accurately—

the 1968 regulations anticipated that "a sufficiently similar transaction" may be unavailable for comparison. *Id.* at 5853. To address circumstances where that is so, the regulations listed twelve factors that "may be considered in arriving at the amount of the arm's length consideration." *Ibid.*; see 26 C.F.R. 1.482-2(d)(2)(iii) (1969).

The 1968 regulations also introduced the concept of a "bona fide cost sharing arrangement," defined as an agreement "between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced." 33 Fed. Reg. at 5854; see 26 C.F.R. 1.482-2(d)(4) (1969). For example, a U.S. corporation and its foreign subsidiary might agree to share the costs of research and development (R&D) for new technology. The regulations stated that the Internal Revenue Service (IRS) would "not make allocations" under Section 482 with respect to such an arrangement, "except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property." 26 C.F.R. 1.482-2(d)(4) (1969). The regulations provided that, "[i]n order for the sharing of costs and risk 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." *Ibid.*

b. In 1986, Congress amended Section 482 by adding a second sentence that specifically addressed controlled-party transactions involving transfers of intangible property. See Tax Reform Act of 1986, Pub. L. No. 99-514, Tit. XII, Subtit. D, § 1231(e)(1), 100 Stat. 2562-2563. The version of that provision in effect during the

years at issue here stated: "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." 26 U.S.C. 482 (2000).

Unlike Treasury's approach in the 1968 regulations, the commensurate-with-income provision does not require consideration of comparable transactions between uncontrolled parties. Congress declined to follow that approach in this context because of the "recurrent problem [of] the absence of comparable arm's length transactions between unrelated parties." H.R. Rep. No. 426, 99th Cong., 1st Sess. 423-425 (1985) (1985 House Report). The commensurate-with-income provision instead requires only an internal comparison, focused on evaluating the income that each controlled party will earn from the intangible property.

The conference report accompanying these amendments explained that the commensurate-with-income provision would not "preclude the use of certain bona fide research and development cost-sharing arrangements" between controlled parties, as long as the "income allocated among the parties reasonably reflect[s] the actual economic activity undertaken by each." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. II, at 638 (1986). The report further stated that, "[u]nder such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs," and that the allocation of such costs "generally should be proportionate to profit." *Ibid.*

After the 1986 legislation was enacted, Treasury performed a comprehensive study of controlled transactions. See IRS Notice 88-123, 1988-2 C.B. 458 (1988)

(White Paper). That study "confirmed that 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)," even though the commensurate-with-income standard relies on comparing the two sides of the controlled-party transaction, rather than comparing the controlled-party transaction to one or more identified transactions between uncontrolled parties. Pet. App. 14a-15a; see, *e.g.*, White Paper 476-477, 482 (referring to the "traditional approach of looking to comparable transactions," and discussing an "alternative method of analysis" for the arm's-length standard that "does not directly rely upon comparable transactions").

c. In 1994 and 1995, Treasury issued new implementing regulations for Section 482. See 59 Fed. Reg. 34,971 (July 8, 1994); 60 Fed. Reg. 65,553 (Dec. 20, 1995). The 1994 rulemaking—which encompassed all of the implementing regulations except for the cost-sharing regulation—generally continued to use comparable transactions to determine an arm's-length result, defined as "the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." 26 C.F.R. 1.482-1(b)(1) (1995). But Treasury also introduced alternative approaches that were not dependent on the existence of comparable uncontrolled transactions in some circumstances. See, *e.g.*, 26 C.F.R. 1.482-6(c)(3) (1995) (residual profit-split method).

In 1995, Treasury revised the cost-sharing regulation and omitted the prior version's reference to comparable transactions. See p. 4, *supra*. The revised regulation instead provided that the IRS would "not make

allocations with respect to a qualified cost sharing arrangement 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." 26 C.F.R. 1.482-7(a)(2) (1996). The regulation defined the term "[c]osts" to include "operating expenses." 26 C.F.R. 1.482-7(d)(1) (1996).

d. The IRS subsequently took the position that the cost of stock-based compensation for employees, like other employee compensation costs, was part of the operating expenses that should be taken into account in applying the cost-sharing regulation, and that requiring such costs to be included in the cost-sharing pool was consistent with the arm's-length standard. See, *e.g.*, IRS Field Service Advisory, 1997 WL 33107193 (Feb. 21, 1997). The "cost" aspect of that position accorded with the historical treatment of employee stock options as giving rise to a deductible compensation expense to the employer under federal tax law in certain circumstances, see, *e.g.*, 26 U.S.C. 83(h) (1970), as well as with contemporary financial accounting standards, see Fin. Accounting Standards Bd., *Statement of Financial Accounting Standards No. 123: Accounting for Stock-Based Compensation* 2 (Oct. 1995).

The IRS's position did not prevail in litigation. In *Xilinx Inc.* v. *Commissioner*, 125 T.C. 37 (2005), the Tax Court held that the IRS could not require related cost-sharers to share stock-based compensation costs without evidence of comparable transactions in which unrelated parties had shared such costs, and that the record contained no such evidence. *Id.* at 54, 58-62. That holding was based primarily on the Tax Court's

understanding of 26 C.F.R. 1.482-1(b)(1) (1995) as requiring consideration of comparable transactions in essentially all cases, whenever "identical" transactions were unavailable for comparison. *Xilinx*, 125 T.C. at 55. The court thus rejected the Commissioner's view that identifying comparable transactions was unnecessary because application of the regulation specifically addressing cost-sharing arrangements, 26 C.F.R. 1.482-7 (1996), would itself "'produce[] an arm's length result,'" *Xilinx*, 125 T.C. at 54 (citation omitted).

A divided panel of the Ninth Circuit initially reversed, holding that Section 1.482-7(d)(1), "as the more specific of the two provisions, controls" over the more general "arm's length standard." *Xilinx, Inc.* v. *Commissioner*, 567 F.3d 482, 496 (2009), withdrawn, 592 F.3d 1017 (9th Cir. 2010). In response to the taxpayer's petition for rehearing, the Commissioner agreed with that result but disagreed with the majority's reasoning, noting that the arm's-length standard applies "in every case." 26 C.F.R. 1.482-1(b)(1) (1995). The panel then withdrew its opinion and issued a new one, this time affirming the Tax Court—again by a 2-1 vote. In that opinion, the panel majority concluded that the regulatory scheme "establish[es] an ambiguous standard for determining which costs must be shared," and that the ambiguity should be resolved in favor of the comparability analysis referred to in Section 1.482-1(b)(1), "based on the dominant purpose of the regulations." *Xilinx, Inc.* v. *Commissioner*, 598 F.3d 1191, 1196 (9th Cir. 2010); see also *id.* at 1197-1199 (Fisher, J., concurring).

2. While the *Xilinx* litigation was pending, Treasury undertook the rulemaking at issue here. See 67 Fed. Reg. 48,997 (July 29, 2002) (notice of proposed rulemaking). A chief purpose of that rulemaking was to "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," *id.* at 48,998—as the Commissioner believed was already true under the best reading of the then-existing regulations. The rulemaking notice also explained that the cost-sharing regulation, Section 1.482-7, "implements the commensurate with income standard" that had been added to 26 U.S.C. 482 in 1986, which Congress understood to be "consistent[] with the arm's length standard." 67 Fed. Reg. at 48,998. Accordingly, the proposed amendments also "include[d] 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." *Ibid.*

In 2003, after receiving written comments and holding a public hearing, Treasury issued a final rule. 68 Fed. Reg. 51,171 (Aug. 26, 2003). The final rule amended Section 1.482-1(b)(2) to make clear—contra the taxpayer's position in *Xilinx*—that "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." 26 C.F.R. 1.482-1(b)(2)(i) (2004). The final rule also amended Section 1.482-7 to confirm that "a controlled participant's operating expenses include all costs attributable to compensation, *including stock-based compensation*." 26 C.F.R. 1.482-7(d)(2) (2004) (emphasis added). And, consistent with the view the Commissioner urged in *Xilinx*, the amendments provided that 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 * * * of intangible development * * * equals its share of reasonably anticipated benefits attributable to such development." 26 C.F.R. 1.482-7(a)(3) (2004). Those amendments applied beginning with the 2004 tax year. See 68 Fed. Reg. at 51,176.

In the preamble to its final rulemaking, Treasury noted that it had received comments objecting to "taking stock-based compensation into account" in this context, based primarily on "third-party evidence" that uncontrolled parties dealing at arm's length "do not take stock-based compensation into account" in crafting allegedly comparable development agreements. 68 Fed. Reg. at 51,172. In response, Treasury explained that it "continue[d] to believe that requiring stock-based compensation to be taken into account for purposes of [qualified cost-sharing arrangements] is consistent with the legislative intent underlying Section 482 and with the arm's length standard." *Ibid.* Treasury also reiterated that it understood the 1986 statutory amendment to reflect a congressional judgment "to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard," if all development-related costs —"determined on a comprehensive basis"—are shared in proportion to anticipated benefits. *Ibid.* Treasury also stated that unrelated parties "dealing at arm's length in such an arrangement * * * generally would not distinguish between stock-based compensation and other forms of compensation." *Id.* at 51,173; see *ibid.* ("Treasury and the IRS believe that if a significant element of [employee] 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.").

3. a. This case arises from the IRS's application of the cost-sharing regulation, as amended by the 2003 final rule, to petitioners—Altera Corporation (Altera) and its U.S. subsidiaries—for tax years 2004 to 2007. During the relevant period, Altera was the publicly traded parent company of a multinational enterprise that "designed, manufactured, marketed, and sold programmable logic devices, which are electronic components that are used to build circuits." Pet. App. 18a. One of its subsidiaries during that period was Altera International, Inc., a Cayman Islands company incorporated in January 1997 (Altera-Cayman). *Ibid.*; see Gov't C.A. E.R. 129. In May 1997, Altera and Altera-Cayman entered into a cost-sharing arrangement for R&D, in which Altera retained the right to exploit any fruits of the R&D in the United States and Canada while permitting Altera-Cayman to do the same in the rest of the world. Pet. App. 18a-19a; Gov't C.A. E.R. 108-109.

On their 2004-2007 federal income-tax returns, petitioners accounted for Altera's cost-sharing arrangement with Altera-Cayman by reporting cost-sharing payments from Altera-Cayman that were based on a cost-sharing pool that did not include Altera's R&D-related stock-based compensation costs. Pet. App. 20a. In two notices of deficiency covering those years, the IRS increased the group's income to reflect the increased cost-sharing payments required by application of the cost-sharing regulation, 26 C.F.R. 1.482-7 (2004), as amended in 2003. Pet. App. 20a. Petitioners timely filed Tax Court petitions challenging the deficiency notices. *Ibid.*

b. The Tax Court found for petitioners. Pet. App. 79a-139a. As relevant here, the court held that the agency's 2003 final rule amending the cost-sharing reg-

ulation was arbitrary and capricious under the Administrative Procedure Act (APA), 5 U.S.C. 551 *et seq.*, because the agency had failed to engage in "reasoned decisionmaking." Pet. App. 111a (citing *Motor Vehicle Mfrs. Ass'n* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)). The court understood its prior decision in *Xilinx* to have held that "the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances." *Id.* at 118a (citing *Xilinx*, 125 T.C. at 53-55). Stating that "Treasury necessarily decided an empirical question," *ibid.*, the court concluded that Treasury could not adopt a regulation that requires the sharing of stock-based employee compensation costs absent evidence (which the administrative record did not contain) demonstrating that unrelated parties would share such costs in comparable circumstances, see *id.* at 121a-127a. After concluding that the rule was invalid under *State Farm*, the court stated that, for the same reasons, the rule would also be an unreasonable interpretation of the statute under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Pet. App. 138a n.29.

4. The court of appeals reversed, upholding the 2003 final rule. Pet. App. 1a-78a.[1]

a. After reviewing the extensive history of Section 482 and its implementing regulations, Pet. App. 7a-18a, the court of appeals determined that the statute "does

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[1] In July 2018, after Judge Reinhardt's death, a divided panel that included Judge Reinhardt as a member of the majority had issued an opinion that also reversed the Tax Court. Pet. App. 262a-322a; see *id.* at 262a n.*. That opinion was later withdrawn, *id.* at 323a; a third judge chosen at random was added to the panel, *id.* at 1a n.*; and the reconstituted panel issued a similar divided opinion in June 2019, after supplemental briefing and re-argument.

not speak directly" to whether Treasury may reallocate a controlled taxpayer's income when the taxpayer fails to include stock-based employee compensation costs in the pool of shared costs for a qualified cost-sharing arrangement, *id.* at 24a. The court therefore found the statute "ambiguous," in the sense of leaving "'a gap for [the] agency to fill.'" *Ibid.* (quoting, indirectly, *Chevron*, 467 U.S. at 843). The court proceeded to "*Chevron* step two," *id.* at 25a, and found that the cost-sharing regulation, as amended by the 2003 final rule, reflected a reasonable interpretation of Section 482, *id.* at 25a-31a. The court emphasized that the purpose of Congress's 1986 amendment to Section 482, which added the commensurate-with-income provision governing transfers and licenses of intangible property (see pp. 4-5, *supra*), "was to ensure that income follows economic activity." *Id.* at 26a. In the court's view, Treasury had acted reasonably in this context by "adopt[ing] a methodology" for allocating income that likewise "follow[s] actual economic activity," *ibid.*, which could be achieved only if all development-related costs—including stock-based compensation costs—were included in the cost-sharing pool.

The court of appeals also held that the agency had reasonably interpreted Section 482 not to require consideration of allegedly comparable transactions between uncontrolled parties. Pet. App. 26a. The court explained that, by adding the commensurate-with-income provision to Section 482, Congress had "granted Treasury authority to develop methods that did not rely on analysis of * * * comparable transactions," given the "'extreme difficulties'" of locating truly comparable transactions involving intangible property. *Id.* at 26a-27a (quoting 1985 House Report 425). The court also

explained that "historically" the methods used to determine an arm's-length result have been "fluid" and have not always relied on comparable uncontrolled transactions. *Id.* at 28a. The court found that this "historic versatility of methodology" supported Treasury's interpretation of the statute as authorizing "an internal method of allocation" for cost-sharing arrangements, focused on the controlled parties themselves, rather than on an "analysis of comparable transactions." *Id.* at 28a-29a.

b. Applying "*State Farm* scrutiny," the court of appeals concluded that Treasury, in promulgating the 2003 final rule, had "complied with the procedural requirements of the APA." Pet. App. 32a. Petitioners contended that Treasury had not adequately responded to comments asserting that unrelated parties would not share the cost of stock-based employee compensation. In rejecting that argument, see *id.* at 33a-37a, the court explained that those comments (and petitioners' APA challenge based on them) "overlook[ed] Treasury's decision to do away with analysis of comparable transactions" in the cost-sharing context—a decision that Treasury had made "clear enough" in the rulemaking preambles' discussions of the statutory scheme and legislative history. *Id.* at 36a. The court also noted with approval Treasury's conclusion during the rulemaking that the purportedly comparable transactions identified by commenters were not sufficiently similar to qualified cost-sharing arrangements "to provide grounds for accurate comparison," which "reinforced Treasury's premise for adopting the purely internal methodology." *Id*. at 37a.

Petitioners contended that Treasury was attempting to substitute a new rationale on appeal for the reasoning

it had given in the rulemaking, in contravention of *SEC* v. *Chenery Corp.*, 332 U.S. 194 (1947). Petitioners also argued that the agency had failed to acknowledge and explain a significant change in policy during the rulemaking, in contravention of *FCC* v. *Fox Television Stations, Inc.*, 556 U.S. 502 (2009). The court of appeals rejected those arguments. See Pet. App. 37a-40a, 42a-44a.

The court of appeals found that Treasury's position on appeal—that the agency "was statutorily authorized to dispense with comparability analysis" in this context, Pet. App. 38a (citation omitted)—was the same position the agency had adopted as "a necessary presupposition of [its] decision" to promulgate the 2003 final rule. *Ibid.* (quoting *National R.R. Passenger Corp.* v. *Boston & Maine Corp.*, 503 U.S. 407, 420 (1992)). The court further explained that "Treasury asserted then, and still asserts in this litigation, that using an internal method of reallocation is consistent with the arm's length standard." *Id.* at 39a. The court rejected petitioners' *Fox Television* challenge for similar reasons: "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." *Id.* at 44a.

c. Judge O'Malley dissented. Pet. App. 47a-78a. She would have held that Treasury's explanation of the 2003 final rule was deficient under *State Farm* because Treasury had not provided an adequate explanation for what she described as a "change [in] its longstanding practice of employing the arm's length standard and using a comparability analysis to get there." *Id.* at 49a; see *id.* at 58a-67a. She also would have held that the "regulations are impermissible under *Chevron*," based

on the theory that the commensurate-with-income provision in Section 482 applies only to licenses or transfers of "already existing intangible property" and thus is inapplicable to cost-sharing arrangements to *develop* intangible property. *Id.* at 67a, 70a.

d. The court of appeals denied petitioners' request for rehearing en banc. Pet. App. 146a. Judge Milan Smith, joined by Judges Callahan and Bade, dissented from the denial of rehearing, largely for the reasons given in Judge O'Malley's dissent and the Tax Court's decision. *Id.* at 146a-167a. Judge Smith also explained that, because the Tax Court could give effect to its own view of the law in any future case that would be appealable to a different court of appeals, the "meaning of the arm's length standard" in this context would remain an open question "outside the Ninth Circuit." *Id.* at 165a.

ARGUMENT

The court of appeals correctly held that Treasury's 2003 final rule, in which the agency amended its regulations to clarify that controlled parties must include the cost of stock-based employee compensation within the pool of shared costs for a qualified cost-sharing arrangement, was not arbitrary or capricious under the APA. The court's decision does not conflict with the decision of this Court or of any other court of appeals. Indeed, no other Article III court has reviewed the regulatory amendments at issue here, and the Tax Court has not yet had the opportunity to reconsider its prior position in light of the decision below. Further review is not warranted.

1. Petitioners principally contend (Pet. 14-16) that, in upholding the challenged rule, the court of appeals misapplied this Court's decision in *Motor Vehicle Man-*

ufacturers Ass'n v. *State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983). The court of appeals considered petitioners' *State Farm* arguments and correctly rejected them. Pet. App. 33a-37a.

a. The APA requires courts to "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). The "scope of review under the 'arbitrary and capricious' standard is narrow," *FERC* v. *Electric Power Supply Ass'n*, 136 S. Ct. 760, 782 (2016) (quoting *State Farm*, 463 U.S. at 43), and a reviewing court "may not substitute [its] judgment for that of the" agency to which Congress has entrusted the authority to make administrative policy, *Department of Commerce* v. *New York*, 139 S. Ct. 2551, 2569 (2019). The reviewing court instead must "confine [itself] to ensuring that [the agency] remained 'within the bounds of reasoned decisionmaking.'" *Ibid.* (quoting *Baltimore Gas & Elec. Co.* v. *Natural Res. Def. Council, Inc.*, 462 U.S. 87, 105 (1983)). That reasoned-decisionmaking requirement "is satisfied when the agency's explanation is clear enough that its 'path may reasonably be discerned.'" *Encino Motorcars, LLC* v. *Navarro*, 136 S. Ct. 2117, 2125 (2016) (quoting *Bowman Transp., Inc.* v. *Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 286 (1974)).

The court of appeals correctly identified those governing legal precepts and correctly applied them to Treasury's 2003 final rule. See, *e.g.*, Pet. App. 33a (explaining that, "[u]nder *State Farm*, the touchstone of 'arbitrary and capricious' review under the APA is 'reasoned decisionmaking'") (citation omitted). As explained above (see pp. 8-10, *supra*), Treasury undertook the rulemaking challenged here in order to "clarify," in light of the *Xilinx* litigation, what the agency already believed to

be the best understanding of the pre-amendment version of the regulations. 67 Fed. Reg. at 48,998. Before the 2003 final rule was promulgated, the cost-sharing regulation stated that the IRS would "not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs * * * of intangible development under the * * * arrangement equal to its share of reasonably anticipated benefits attributable to such development." 26 C.F.R. 1.482-7(a)(2) (1996). The regulations specified that intangible development costs included "operating expenses," the definition of which in turn encompassed employee compensation. 26 C.F.R. 1.482-7(d)(1) (1996); see 26 C.F.R. 1.482-5(d)(3) (1996) (defining operating expenses to include generally "all expenses not included in cost of goods sold," except interest and taxes). The regulations did not suggest that stock-based employee compensation should be treated differently from other forms of employee compensation.

The purpose and effect of the 2003 amendments was to make explicit what the Commissioner maintained was implicit in the pre-amendment regulations—namely, that related participants in a qualified cost-sharing arrangement must share all R&D-related costs in proportion to their shares of reasonably anticipated benefits in order to achieve the paradigmatic arm's-length result, and that stock-based compensation gives rise to a cost for these purposes. Neither of those determinations required the agency to "examine * * * relevant data" or to engage in fact-finding, *State Farm*, 463 U.S. at 43, because the agency was not "making an empirical judgment like that underlying the seatbelt regulation that was invalidated in *State Farm*," Richard

W. Skillman, *The Problems with* Altera, 150 Tax Notes 347, 353 (Jan. 18, 2016). The agency was instead clarifying its implementation of 26 U.S.C. 482 in the specific context of qualified cost-sharing arrangements.

b. Petitioners' attacks on the 2003 final rule largely conflate (i) the arm's-length standard, *i.e.*, the longstanding rule 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," 26 C.F.R. 1.482-1(b)(1); and (ii) the use of comparability analysis, *i.e.*, the examination of actual, identified transactions between uncontrolled entities as a means of achieving an arm's-length result. Petitioners contend that, by eschewing comparability analysis in the context of controlled-party agreements to develop intangible property, Treasury has abandoned the arm's-length standard itself. Those arguments reflect a misunderstanding of the relationship between the two concepts.

During the rulemaking, the agency stated that it "d[id] not agree with the comments that assert that taking stock-based compensation into account in the [qualified cost sharing arrangement] 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." 68 Fed. Reg. at 51,172. Treasury explained that, "[w]hile 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 [qualified cost-sharing arrangements] such data may not be available." *Id.* at 51,172-51,173. Treas-

ury further explained that "[t]he uncontrolled transactions cited by commentators do not share enough characteristics" with the typical qualified cost-sharing arrangement "to establish that parties at arm's length would not take stock options into account in the context of [such] an arrangement." *Id.* at 51,173. The agency viewed the commensurate-with-income statutory provision implemented in the regulation, not as an alternative to the arm's-length standard, but as an alternative to comparability analysis as a means of achieving an arm's length result. See *ibid.* (explaining that the cost-sharing regulations "have as their focus reaching results consistent with what parties at arm's length generally would do"). The court of appeals upheld the final rule on the same rationale. See Pet. App. 36a-37a, 39a.

c. Petitioners contend (Pet. 15-16) that Treasury could not require participants in a qualified cost-sharing arrangement to share stock-based employee compensation costs without "an empirical and factual analysis of real-world behavior of unrelated parties," and that the 2003 final rule was unsupported by empirical data and contrary to the evidence before the agency. As noted above, that argument reflects petitioners' conflation of the arm's-length standard (which continues to apply in this context) and the analysis of specific comparable transactions between unrelated parties. See Pet. App. 26a-28a, 34a, 36a-37a. Comparing a controlled-party transaction to an identified transaction between uncontrolled parties is one method of determining an arm's-length result, but it is not the only method.

In particular, Section 482 states that, for controlled-party transactions involving "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." 26 U.S.C. 482. Congress added that language in 1986, in part out of concern that the comparability approach reflected in Treasury's prior regulations was ill-suited to controlled-party transactions involving transfers of intangible property (for which truly comparable transactions may be difficult or impossible to find). See Tax Reform Act of 1986, § 1231(e)(1), 100 Stat. 2562-2563; 1985 House Report 423-425; pp. 4-5, *supra*.

By its plain terms, Section 482 does not require any analysis of identified comparable transactions between unrelated parties. And the cost-sharing regulation challenged here implements the commensurate-with-income provision, as Treasury explained in the rulemaking process. See 67 Fed. Reg. at 48,998. The amended regulatory text—both as initially proposed and as finally adopted—makes plain that a qualified cost-sharing arrangement produces results that are consistent with an arm's-length result "if and only if" it complies with the rules set forth in the cost-sharing regulation itself, which does not contemplate any analysis of allegedly comparable transactions and which mandates the inclusion of stock-based employee compensation in operating costs. 26 C.F.R. 1.482-7(a)(3) and (d)(2) (2004); see 68 Fed. Reg. at 51,177-51,178; 67 Fed. Reg. at 49,002.

Petitioners suggest (Pet. 15-16) that the agency led interested parties to believe that it would rely on data about specific comparable transactions between unrelated parties, and that tax professionals who submitted comments "took the government at its word." As just explained, however, the proposed text of the rule refutes that suggestion. An interested party who read the notice of proposed rulemaking, including the text of the

proposed rule, could not reasonably have expected Treasury to rely on any analysis of actual, allegedly comparable transactions between uncontrolled parties. Cf., *e.g.*, Pet. C.A. Supp. E.R. 167 (commenter recognizing that "[t]he proposed regulation would make any evidence of comparable transactions irrelevant" in this context). And Treasury did not "ignore[]" (Pet. 16) the comments it received about supposedly comparable transactions between unrelated parties. The agency instead explained that those comments did not cast doubt on the soundness of the agency's approach for the reasons stated above, *i.e.*, because the arm's-length standard can be implemented through means other than comparability analysis, and because the purportedly comparable transactions identified by the commenters were not sufficiently similar to qualified cost-sharing arrangements to provide a reliable basis for comparison. See pp. 19-20, *supra*.

In the preamble to its final rule, Treasury also expressed the view that, if uncontrolled parties agree to share the costs of developing intangible property, and one of the parties is considering a commitment of several employees to the arrangement, that party would not do so "unless the other party agrees to reimburse its share of the compensation costs of the employees." 68 Fed. Reg. at 51,173. Treasury then stated its "belie[f] that if a significant element of that compensation consists of stock-based compensation," then "the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation." *Ibid*. That statement was consistent with the underlying premise of the commensurate-with-income provision (*i.e.*, that uncontrolled parties,

when collaborating in a profit-seeking endeavor, will ordinarily allocate the associated costs in a manner proportionate to the income each expects to receive), and it explained "why treating stock-based compensation as a cost [leads] to [an] arm's length result[]," Pet. App. 40a, as defined in Section 1.482-1(b)(1).

The 2003 final rule implements a statutory authority—Section 482's commensurate-with-income provision—that does not require any empirical analysis of identified comparable transactions between unrelated parties. Petitioners' principal *State Farm* challenge to the rule faults the agency for disregarding evidence about supposedly comparable uncontrolled transactions. The court of appeals recognized, however, that the purportedly comparable transactions cited by some commenters "actually reinforced the original justification for adopting a purely internal methodology—the lack of transactions comparable to those occurring between parties to a [qualified cost-sharing arrangement]." Pet. App. 37a. The court explained that, "[b]ecause 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." *Ibid.*; see 26 C.F.R. 1.482-1(a)(1) (identifying "tax parity" purpose).

2. Petitioners also seek (Pet. i) review of the question whether, "under *SEC* v. *Chenery Corp.*, 332 U.S. 194 (1947), [a] regulation may be upheld on a rationale the agency never advanced during rulemaking." This case does not implicate that question. The court of appeals recognized that a reviewing court "must judge the propriety of agency action solely by the grounds invoked by the agency." Pet. App. 37a-38a (quoting *Chenery*, 332 U.S. at 196) (brackets omitted). The court

further recognized, however, that Treasury's position in litigation was consistent with the rationale the agency had offered for its action during the rulemaking. See *id.* at 37a-40a. The court thus upheld Treasury's action on grounds that the agency itself had invoked. And petitioners' fact-bound disagreement with the court of appeals' understanding of the administrative record does not warrant this Court's review.

The court of appeals was plainly correct to reject petitioners' *Chenery* argument. In the rulemaking process, Treasury explained that the cost-sharing regulation implements the commensurate-with-income provision that was added to Section 482 in 1986. 67 Fed. Reg. at 48,998. The agency stated that Congress intended that the commensurate-with-income provision would be applied to cost-sharing arrangements "consistently with the arm's length standard," *ibid.*, even though the commensurate-with-income provision does not require consideration of comparable transactions between uncontrolled parties. See Pet. App. 14a-15a; White Paper 482. In the preamble to the 2003 final rule, Treasury reiterated its view that requiring stock-based employee compensation to be taken into account for qualified cost-sharing arrangements was "consistent with the legislative intent underlying section 482 and with the arm's length standard." 68 Fed. Reg. at 51,172.

In defending the 2003 final rule in litigation, Treasury repeated its understanding of Congress's intent regarding the operation of the arm's-length standard in this context, and explained that its determination in that regard was not empirical. See Pet. App. 39a (observing that Treasury "asserted then, and still asserts in this litigation, that using an internal method of reallocation is consistent with the arm's length standard");

see also, *e.g.*, Gov't C.A. Br. 57-64 (explaining and defending the reasoning set forth by the agency in the rulemaking notices). Petitioners are thus wrong in suggesting (Pet. 17) that Treasury "abandon[ed]" the arm's-length standard. The agency has consistently maintained that application of the cost-sharing regulation implementing the commensurate-with-income provision would produce an arm's-length result, even though the regulation does not contemplate analyzing identified transactions between uncontrolled parties.[2]

Finally, petitioners observe (Pet. 17) that the preamble to the final rule "mentioned the 'commensurate with the income' language only once." The notice of proposed rulemaking refers to that provision numerous times. In any event, once would be enough. An agency must set forth the basis of its action "with such clarity as to be understandable," *Chenery*, 332 U.S. at 196, and the agency did so here. Neither *Chenery* nor any other principle of administrative law required Treasury also "to provide 'exhaustive, contemporaneous legal arguments to preemptively defend its action.'" Pet. App. 38a (quoting *National Elec. Mfrs. Ass'n* v. *United States Dep't of Energy*, 654 F.3d 496, 515 (4th Cir. 2011)).

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[2] Treasury took the same position (albeit unsuccessfully) in defending the pre-amendment versions of Sections 1.482-1 and 1.482-7 in the *Xilinx* litigation. See pp. 7-8, *supra*. A principal purpose of the 2003 final rule was to "clarify" what the agency believed to be the best reading of the pre-amendment regulations. 67 Fed. Reg. at 48,998. And petitioners can hardly claim to have been surprised by the agency's view that stock-based employee compensation costs must be included in shared costs in this context, since Altera had entered into an agreement with the IRS in December 1999 for the pre-2004 tax years in which its own stock-based compensation costs were included in the pool of shared costs for its cost-sharing arrangement with Altera-Cayman. Pet. App. 19a; see Gov't C.A. E.R. 139.

3. Petitioners also seek review (Pet. i) of the question whether a "procedurally defective regulation may be upheld under *Chevron* on the ground that the agency has offered a 'permissible' interpretation of the statute in litigation." That question likewise is not implicated here. The court of appeals rejected petitioners' premise that Treasury had issued the 2003 regulation in a procedurally defective manner. Pet. App. 31a-44a (concluding that "the 2003 regulations are not arbitrary and capricious under the standard of review imposed by the APA"). The court separately found that Treasury's resolution of the precise interpretive question this case presents—*i.e.*, whether stock-based compensation costs should be included in the pool of shared costs for a qualified cost-sharing arrangement to develop intangible property—was permissible under *Chevron*. See *id.* at 23a-31a. Neither of those holdings suggests that the Ninth Circuit would sustain a "procedurally defective" regulation under *Chevron*. And neither holding warrants further review, let alone supports petitioners' extraordinary suggestion of summary reversal (Pet. 22).

Petitioners suggest (Pet. 20) that, because the "Tax Court had invalidated the regulation under the APA's reasoned-decisionmaking standard," the court of appeals should have addressed petitioners' *State Farm* arguments before applying *Chevron*. But petitioners identify no sound basis for requiring that order of operations. Petitioners' assertion (*ibid.*) that the court of appeals did not "independently analyze" petitioners' *State Farm* arguments is belied by the extensive analysis the court devoted to those contentions. See Pet. App. 31a ("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."); *id.* at 31a-44a (rejecting each of petitioners' arguments).

Petitioners also contend (Pet. 21) that the court of appeals "erred in giving *Chevron* deference to an agency interpretation offered for the first time in litigation." That argument is unfounded. In applying *Chevron*, the court first concluded that Section 482 does not unambiguously specify whether the cost of stock-based employee compensation must be included in the pool of shared costs for a qualified cost-sharing arrangement. Pet. App. 23a-25a. The relevant statutory provision states simply that, in the case of a transfer or license of intangible property between controlled parties, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." 26 U.S.C. 482.

The court of appeals concluded that, in promulgating the 2003 final rule, Treasury had reasonably construed the statute as authorizing the agency to mandate that any stock-based compensation costs be included, along with other compensation costs, as operating expenses associated with the development of intangible property. Pet. App. 25a-29a; see 26 C.F.R. 1.482-7(d)(2) (2004). The interpretation to which the court deferred was thus the interpretation reflected in the regulation itself, adopted after notice-and-comment rulemaking. Deferring to such an interpretation is not an "expan[sion]" (Pet. 13) of *Chevron* but rather a routine application of it. See *Mayo Found. for Med. Educ. & Research* v. *United States*, 562 U.S. 44, 55-60 (2011) (holding that "[t]he principles underlying * * * *Chevron* apply with full force in the tax context," and according *Chevron*

deference to a Treasury regulation that had been promulgated after notice-and-comment procedures).

Petitioners do not contend that Section 482 itself compels a particular treatment of stock-based employee compensation costs incurred in developing intangible property with a related party. Nor do petitioners question Treasury's statutory authority to adopt a regulation requiring that stock-based employee compensation costs be treated for these purposes like other compensation costs. Petitioners likewise do not suggest that the challenged regulation is ambiguous concerning the treatment of stock-based employee compensation costs (as the Ninth Circuit in *Xilinx* had previously found was the case for the predecessor regulations).[3] Petitioners' limited disagreement with the court of appeals' case-specific application of *Chevron* does not warrant this Court's review.

4. Petitioners' remaining arguments for granting certiorari (Pet. 22-32) are unpersuasive. Petitioners do not advance any substantial argument that the decision below conflicts with the decision of any other court of appeals. Cf. Pet. 21. No other court of appeals has addressed the 2003 final rule. And the decision below will not bind the Tax Court (or any other court) in a case appealable to a court of appeals other than the Ninth Circuit. See Pet. App. 165a (Smith, J., dissenting from

[3] Petitioners' assertion (Pet. 23) that the agency "is seeking to impose tax liability essentially by administrative fiat, rather than th[r]ough any formal agency action," therefore is incorrect. The cost-sharing regulation itself, amended in 2003 pursuant to notice-and-comment procedures, unambiguously dictates that "stock-based compensation" costs be treated for these purposes like other employee compensation costs and included in the pool of shared costs. 26 C.F.R. 1.482-7(d)(2) (2004).

the denial of rehearing en banc). If a substantial division of authority concerning the validity of the 2003 final rule develops in the future, this Court's review may be warranted at that time. But petitioners identify no pressing reason for the Court to intervene now.

Finally, there is no sound basis for petitioners' prediction that the decision below will spawn "serious domestic and international tax consequences." Pet. 28 (emphasis omitted). That forecast is based on petitioners' erroneous premise (*ibid.*) that the court of appeals "allowed [Treasury] to cast the [arm's-length] standard aside for stock-based compensation." The court below repeatedly explained, however, that the 2003 final rule did not abandon the arm's-length standard, but instead permissibly provided that a methodology other than analyzing actual transactions between uncontrolled parties would be used to determine an arm's-length result. See, *e.g.*, Pet. App. 28a (upholding as "reasonable" Treasury's understanding "that Congress intended for it to depart from analysis of comparable transactions as the exclusive means of achieving an arm's length result").

The court of appeals also correctly determined, with respect to petitioners' claims about the prevalence of the arm's-length standard in international tax agreements, that "there is no evidence that [U.S.] treaty obligations bind [the United States] 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." Pet. App. 31a. Indeed, for numerous recent treaties, Treasury has issued technical explanations stating that the commensurate-with-income provision of Section 482 "operates consistently with the arm's-

length standard," and that the administrative implementation of that provision "in the regulations under Code section 482 is in accordance with" the arm's-length standard. *Ibid.* (quoting U.S. Treasury, *Technical Explanation of the Convention Between the United States of America and the Republic of Poland for the Avoidance of Double Taxation* 31 (2013)).[4] The cost-sharing regulation, as amended by the 2003 final rule, is fully consistent with the arm's-length standard and with U.S. tax treaties incorporating that standard.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[4] https://go.usa.gov/xvDN3. Since the promulgation of the 2003 final rule, the United States has negotiated eight other income-tax treaties for which it has issued similar technical explanations. The treaties and technical explanations are available at https://go.usa.gov/xvDNH.