August 1, 2018

Ninth Circuit Upholds IRS Regulation on Allocation of Stock-Based Compensation, Reversing the Tax Court

In an unexpected 2-1 decision, Judge Reinhardt, who passed away in March of this past year, cast the Ninth Circuit's deciding vote to reverse the Tax Court's prior ruling in *Altera*. In 2015, the Tax Court invalidated Treasury Regulation 1.482-7A(d)(2)'s requirement that related parties allocate stock-based compensation costs when entering into cost-sharing agreements to develop intangible assets. The Tax Court's decision in *Altera* centered on the IRS's failure to support the regulation with examples of unrelated parties sharing stock-based compensation costs (comparable uncontrolled transactions). This failure was fatal, according to Judge Marvel of the Tax Court, because to require related taxpayers to share stock-based compensation absent any evidence of similar behavior by unrelated parties would mean the regulation did not seek parity between these groups of taxpayers, contrary to the long-standing arm's-length principle for transfer pricing. As a result, the Tax Court held that the regulation did not meet the reasoned decision-making standard in the *State Farm* Supreme Court case.

The Ninth Circuit took a different approach. Initially, the Ninth Circuit emphasized that section 482 of the Internal Revenue Code was intended to give the IRS broad discretion to reallocate income between related parties to prevent shifting of profits overseas. It described that, even after the emergence of the arm's length standard, the IRS was given leeway to make reasonable allocations of income even if it could not support its action by reference to a comparable uncontrolled transaction. While it acknowledged that a stricter interpretation of the arm's-length standard was applied in subsequent years, the Ninth Circuit viewed the 1986 amendment requiring transfers of intangible property be "commensurate with income" to be a major turning point away from the arm's-length standard's emphasis on comparables.

In this context, the Ninth Circuit turned to the disputed regulation at hand, which was promulgated to overturn a prior decision of the Ninth Circuit in *Xilinx* that held that it was inconsistent with the transfer pricing's arm's-length standard to require related parties to share stock-based compensation costs. The new regulation interpreted stock-based compensation costs as one of "all of the costs" that related parties must allocate in a cost-sharing agreement for development of intangibles. The Ninth Circuit noted that IRS had published the disputed regulation, providing notice and the opportunity to comment, and explained its reasoning in rejecting comments that unrelated parties would not share stock-based compensation in the preamble to the final regulation. As for Altera's challenge that the IRS did not support its final regulation with sufficient evidence under *State Farm*, the Ninth Circuit ruled that industry norms, logic, and accounting principles supported the IRS's position. The Ninth Circuit further held that it was appropriate to defer to the regulation since it was consistent with the commensurate-with-income standard.

The dissent, written by Judge O'Malley of the Federal Circuit, who sat by designation on the panel, vigorously criticized the majority for relying too heavily on the commensurate-with-income standard since it could uphold the regulation under the arm's-length standard. Judge O'Malley would have upheld the Tax Court decision on the grounds that the IRS did not provide adequate notice of its intent to deviate from the arm's-length standard and that the Ninth Circuit's prior decision in *Xilinx* controlled.

This decision has significant implications for many taxpayers. Taxpayers who have revised their transfer pricing policies in response to the Tax Court's decision in *Altera* will need to reevaluate those revisions and consider the risks and benefits of reverting their policies and the risks of readjusting them to be compliant with the regulations at issue. Taxpayers with outstanding refund claims in this area can also expect the IRS to begin denying their claims, potentially pushing them to press their claims in other circuits, or watch and wait to see if *Altera* will reach the Supreme Court. Additionally, the case is a big victory for the IRS and may make it more difficult to challenge regulations under the Administrative Procedure Act, particularly in the Ninth Circuit.