Nos. 16-70496, 16-70497

In the United States Court of Appeals for the Ninth Circuit

ALTERA CORPORATION AND SUBSIDIARIES,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

On Appeal from Decisions of
the United States Tax Court
(Nos. 6253–12, 9963–12)

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INTEREST OF THE *AMICI CURIAE*

Amici are tax and administrative law professors who teach and have written books and numerous articles on taxation and administrative law, including tax administration and U.S. international taxation. *Amici* have a strong interest in the proper application of section 482 of the Internal Revenue Code—the statute authorizing the regulation at issue here—and the appropriate and consistent application of administrative law in the context of tax administration. They file this brief to provide the Court with relevant background information and to advance legal arguments that were given short shrift below.[1]

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INTRODUCTION

At stake is the validity of a 2003 Treasury Department regulation that seeks to prevent avoidance of U.S. taxes. It requires that certain cost-sharing agreements between related entities (like a U.S. corporate parent and its offshore subsidiary) include stock-based compensation as part of the shared "costs," or else be subject to adjustment by the IRS.

The IRS has long had statutory authority to make after-the-fact adjustments to income, particularly as to agreements involving the transfer or license of intangible property. Thirty years ago, in 1986, Congress added a sentence to strengthen the statute authorizing IRS income reallocation, making clear that, in this context, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." 26 U.S.C. § 482. For a cost-sharing agreement to satisfy this requirement, "the income allocated among the parties" should "reasonably reflect the actual economic activity undertaken by each," meaning that "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) (Conf. Rep.).

The 2003 cost-sharing regulation clarifies that "all" indeed means all: It includes the costs of stock-based compensation provided to employees paid to develop the intangible property. That rule is entirely consistent with (and in fact

furthers) congressional intent. A contrary rule would invite manipulation by U.S. corporations seeking to avoid paying taxes—exactly what Congress sought to prevent by adding the commensurate-with-income provision in 1986.

Yet the Tax Court below refused to consider this provision in striking down the cost-sharing regulation because it found that the Treasury Department "did not rely *exclusively* on the commensurate-with-income standard" in its rulemaking. That was error. In asking whether the regulation constitutes a reasonable exercise of Treasury's authority under section 482, the court should have considered the *entire* section—including the commensurate-with-income provision.

Amici file this brief to make four key points. *First*, the 2003 cost-sharing regulation is substantively reasonable under the commensurate-with-income standard. Although we agree with the government that this standard can be harmonized with the standard that generally governs Treasury's rulemaking authority under section 482 (known as the arm's-length standard), the focus of our brief is the commensurate-with-income authority. Properly understood, that authority provides a sufficient independent basis for the regulation. Indeed, the legislative history practically mandates that stock-based compensation be accounted for in cost-sharing agreements.

Second, by requiring that Treasury rely exclusively on its commensurate-with-income authority to avail itself of that authority, the Tax Court misunderstood a

basic principle of administrative law. To be sure, a court "must judge the propriety of [an agency's action] solely by the grounds invoked by the agency." *S.E.C. v. Chenery Corp.*, 332 U.S. 194, 196 (1947). But a court must "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). And here, the cost-sharing regulation may be reasonably understood as an exercise of Treasury's commensurate-with-income authority, and both the notice of proposed rulemaking and the preamble to the final cost-sharing regulation cited this authority.

Third, even if this Court finds that Treasury's explanation of the cost-sharing regulation is inadequate, the taxpayer bears the burden of establishing that any error affected the procedure used or the substance of the decision reached. But it cannot carry this burden, because Treasury considered the comments submitted and responded accordingly. And Treasury reached a substantively reasonable conclusion that addresses the concerns that led Congress to create the commensurate-with-income standard in the first place. Therefore, at a minimum, this Court should remand the regulation to Treasury without vacating it, so that Treasury has an opportunity to clarify its explanation.

Finally, invalidating the regulation would have significant policy consequences, resulting in billions of dollars of lost tax revenue due to this

regulation alone. It would upset the past decade of cost-sharing agreements and adversely impact tax administration in a manner that reaches far beyond the regulation at issue here, at significant cost to the public fisc.

BACKGROUND

I. Transfer pricing and cost-sharing agreements

A. Transfer pricing and the arm's-length standard

To understand the regulation at issue here, it is necessary first to understand the basics of transfer pricing. Transfer pricing refers to the practice of setting prices for exchanges between related parties, such as payments made by a subsidiary corporation for goods or services provided by its parent corporation. These prices can be very important for tax purposes.

Most obviously, if the parent is in a high-tax jurisdiction and its subsidiary is in a low-tax jurisdiction, the enterprise can engineer pricing between the related entities so that more income appears in the low-tax jurisdiction. For example, if the parent corporation can produce goods for $10 per unit in high-tax Country A, and the market price for those goods in low-tax Country B is $100 per unit, then the parent, by charging its subsidiary just $10 per unit, could cause all the profit to be reported in Country B, and none in Country A. So if related parties were able to set transfer prices for tax purposes however they wished, they could shift profits to

low-tax countries at will. The regulation of transfer pricing is therefore critical to the integrity of the U.S. tax base.

Congress has long recognized as much. Through the first sentence of section 482, Congress has expressly authorized Treasury to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between two related organizations if necessary "to prevent evasion of taxes or clearly to reflect the income of any of such organizations." 26 U.S.C. § 482.

In accordance with this authority, Treasury has issued regulations (dating back to the 1930s) establishing that the arm's-length standard should be used to determine adjustments made under this provision. *See* Gov't Br. 5-8. The basic rule under this standard is that true taxable income can generally be determined by reference to "comparable transactions under comparable circumstances" carried out between unrelated parties. 26 C.F.R. § 1.482-1(d)(1). Thus, under the arm's-length standard, if the $10-per-unit goods have a wholesale price of $60 per unit in a comparable transaction between unrelated parties, the IRS can make an adjustment to the related-party transaction to impose that so-called arm's-length price for tax purposes.

B. Transfer pricing and the commensurate-with-income standard

For some related-party transactions, however, comparable unrelated-party transactions may not be available as a point of reference. A classic example is when

the property transferred is unique, as is often the case with intangible property. Congress identified this limitation and, in 1986, sought to address it by adding a second sentence to section 482, granting "commensurate-with-income" authority, which provides the IRS with special power to allocate income generated by intangible property among related parties.

This commensurate-with-income authority looks to the income generated by the intangible property—it does not look to comparable transactions (because they may not exist). In the most straightforward scenario, a parent corporation transfers intangible property (like the design of a new integrated circuit) to its subsidiary in exchange for a royalty to be paid as the new circuit generates income for the subsidiary. Commensurate-with-income authority allows the IRS to make adjustments based on the income generated by the new circuit in the hands of the subsidiary. *See* 26 C.F.R. § 1.482-4(f)(2). For example, if the new circuit were transferred for a fixed royalty of $100 per year (a vast simplification of actual royalty terms), and an IRS examination two years later revealed that the new circuit generated $100,000 of income for the subsidiary in each of those years, the IRS could adjust the royalty amount for tax purposes without reference to comparable agreements between unrelated parties. This after-the-fact adjustment authority thus provides a powerful and important regulatory tool for policing transfer pricing in the case of intangible property.

But intangible property is not always transferred in exchange for a royalty. Sometimes intangible property rights are transferred for tax purposes in accordance with a "cost-sharing agreement"—as in this case—whereby parties agree to split the costs of developing intangible property in exchange for splitting the benefits of the to-be-developed intangible.

C. Example #1 of a cost-sharing agreement: business-driven agreement between unrelated parties

Unrelated parties sometimes enter into joint-development agreements for non-tax business reasons. For example, consider two unrelated businesses (call them "Domestic" and "Foreign"). Domestic wants to design an integrated circuit, and plans to undertake research and development ("R&D") activities using its own U.S. employees in a U.S. facility. If R&D activities cost $100 million, then (absent any joint-development agreement) Domestic will bear the entire $100 million of costs and will have rights to the worldwide exploitation of the new circuit. Under a joint-development agreement between Domestic and Foreign, however, Domestic could keep the right to exploit any new circuit design in North America (assumed to be 30% of the worldwide market) and Foreign might obtain the right to exploit it in the rest of the world (70%). The agreement would provide for a "cost pool" of the entire $100 million. Foreign would then make payments to Domestic in proportion to Foreign's share of the anticipated benefits from the new circuit—here, 70% of $100 million ($70 million). Thus, under the agreement, Domestic's

net costs would be $30 million. As a result, Domestic would have only $30 million of deductible net expenses for U.S.-federal-income-tax purposes.

Why would Domestic enter into such an agreement? It might see risks in the R&D process due to uncertainty about the ultimate profits, and want to share those risks with another party. Or, more realistically, it might want to take advantage of Foreign's distribution network (while Foreign might want to take advantage of Domestic's know-how). Or Foreign and Domestic might each contribute employees with particular expertise, anticipating synergies from collaboration. In short, there are often good business reasons for such agreements.

D. Example #2 of a cost-sharing agreement: tax-driven agreement between related parties

Now consider a cost-sharing agreement between two *related* entities (call them "U.S. Parent" and its wholly-owned subsidiary "Cayman Sub"). This agreement might take the same form as the agreement described above, with the entities splitting the $100 million cost pool 30/70 and the rights to exploit any intangible developed in the same proportions.

But there are at least three key differences in the related-party scenario. *First*, the agreement is unlikely to advance *any* of the non-tax business considerations motivating a cost-sharing agreement between unrelated parties: There is no risk-sharing outside the group; the arrangement does not facilitate capital investment; and any genuine synergies in R&D activities can be exploited without the

agreement. *Second*, U.S. Parent will ultimately bear the entire cost of the activities. Because Cayman Sub is a wholly-owned subsidiary, its $70 million payment must be funded by U.S. Parent (either directly or indirectly). In the simplest case, U.S. Parent will contribute $70 million to Cayman Sub as capital, which Cayman Sub will then pay back to U.S. Parent in accordance with the cost-sharing agreement. This is nothing more than paper-shuffling for tax purposes. *Third*, under this arrangement, U.S. Parent loses the benefit of the full $100-million deduction that would have been available had it paid the entire R&D cost directly. In essence, U.S. Parent trades $70 million in deductible R&D expenses for the ability to place all the foreign profits in a tax haven, where they will not be taxed.

Thus, the related-party agreement serves tax-planning, not business-planning, purposes. Despite the loss of U.S. deductions, the tax benefits can be substantial. If the new circuit generates $1 billion of income outside North America (that is, in the 70% of the world where Cayman Sub has the right to exploit it), that $1 billion may be subject to a *zero-percent* tax rate in the Cayman Islands (or applicable tax rates wherever the intangible is exploited), rather than the 35% U.S. statutory tax rate. U.S. Parent's inclusion of the $70-million cost-sharing payment in its income (which at the 35% rate increases its income-tax liability by nearly $25

million) pales in comparison to the hundreds of millions of dollars in potential tax savings generated by the plan overall.[2]

For many companies, one of the top R&D costs is employee compensation (as explained below). When establishing a cost-sharing agreement between related technology companies, excluding stock-based compensation from the cost pool can significantly affect how the parties split the costs (and thus how much is paid in U.S. taxes). If $25 million of the $100 million R&D expense consists of stock-based-compensation costs, and the parties exclude that cost from the cost pool, then Cayman Sub will make a cost-sharing payment of only $52.5 million (70% of $75 million) rather than $70 million. That would decrease U.S. Parent's income by $17.5 million (because it receives a $52.5 million cost-sharing payment, rather than $70 million), thus decreasing its income-tax liability by approximately $6.125 million (assuming the 35% corporate tax rate). And it still gets to place all its foreign profits in a tax haven.

II. Treasury's cost-sharing regulation

The 2003 cost-sharing regulation seeks to prevent this scenario. It provides that, if related parties share intangible-property-development costs "in proportion to their shares of reasonably anticipated benefits" from the exploitation of the

[2] U.S. Parent can avoid U.S. tax on the Cayman Sub's income indefinitely by abstaining from making distributions from Cayman Sub to U.S. Parent.

intangibles, the IRS will *not* make adjustments between the parties. 26 C.F.R. § 1.482-7A(d)(2); *see* 68 Fed. Reg. 51,171 (Aug. 26, 2003).[3]

To return to the scenario described above, as long as the 30/70 split reflects the "reasonably anticipated benefits" of the respective related parties, and the parties actually split the costs in that proportion, the regulation provides that the IRS will let the cost-sharing agreement control the future allocation of income attributable to the intangible exploited by Cayman Sub—what the government refers to as the "cost-benefit allocation principle." Gov't Br. 60-61. But if the costs are *not* split proportionately to future benefits (say, by excluding stock-based compensation costs from the pool), the IRS may adjust the payments between the parties to reflect U.S. Parent's income appropriately. Importantly, these adjustments can be based on the actual income generated by the intangible property under the commensurate-with-income authority.

Adopting the cost-sharing regulation's methodology is not required: Taxpayers may enter into any business arrangement they want with related entities. Complying with the regulation simply acts as a safe harbor for taxpayers, protecting them against subsequent adjustments that might otherwise result from an IRS examination and application of its commensurate-with-income authority. *See* Gov't Br. 53-54.

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[3] 26 C.F.R. § 1.482-7A(d)(2) applies to taxable years before January 2009. An updated regulation, section 1.482-7(d)(3), applies to subsequent years.

The facts of this case illustrate the importance of the regulation to preserving the integrity of the U.S. tax base. Altera's tax returns and cost-sharing agreements for the relevant years reveal that Altera's U.S. parent company entered into a cost-sharing agreement with its Cayman Islands subsidiary. That agreement did not include the cost of stock-based compensation, which were disproportionately incurred by the U.S. parent, and consequently the Cayman subsidiary paid far less than its proportionate share of the actual costs of the intangible-development activities. Had those costs been included, the cost-sharing payments from the Cayman subsidiary would have increased Altera's U.S. income by between $15 million and $24.5 million per year, thus increasing Altera's U.S. income tax liability. ER 15.

ARGUMENT

I. The cost-sharing regulation is a substantively reasonable exercise of the Treasury Department's authority under section 482.

When Congress added the commensurate-with-income language to section 482 in 1986, its intent was clear: to ensure that "the division of income between related parties reasonably reflect[s] the relative economic activity undertaken by each." H.R. Rep. No. 99-841, at II-637. By stressing the importance of the actual economic activity, Congress was signaling that Treasury would not be required to focus on "industry norms or other unrelated party transactions" if they would not

exist in a particular context (like "related party intangibles transfers"). H.R. Rep. No. 99-426, at 425 (1985).

Cost-sharing agreements like those at issue here are one such context. The legislative history shows that Congress contemplated how the commensurate-with-income authority should apply to these agreements, and described in some detail the very problem that the cost-sharing regulation addresses—the challenge of dealing with pricing high-value intangibles:

> *A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties.*… The problems are particularly acute in the case of transfers of high-profit potential intangibles.… Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases. Transfers between related parties do not involve the same risks as transfers to unrelated parties.

H.R. Rep. No. 99-426, at 424-25 (emphasis added).[4] Because of the frequent unavailability of comparable arm's-length transactions in this context, Congress amended the statute to provide for commensurate-with-income authority.

In doing so, Congress also gave some indication of how that authority should apply to cost-sharing agreements. *See* Gov't Br. 55-57. The House Conference Report explained that cost-sharing agreements were "an appropriate method of

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[4] The Tax Court's opinion quoted this report at greater length, but excised the language italicized above, along with other relevant language that supports the application of commensurate-with-income authority to cost-sharing agreements. The government's brief quotes the relevant legislative history more extensively (at 52-53).

allocating income attributable to intangibles" so long as "the income allocated among the parties reasonably reflect the actual economic activity undertaken by each." H.R. Rep. No. 99-841, at II-638. And the Report made clear that sharing "all research and development costs" is a sufficient proxy for "actual economic activity." *Id.*

In light of this history, the 2003 cost-sharing regulation should be upheld as consistent with congressional intent. Indeed, because stock-based compensation is a cost (as explained in Part II.B.), the legislative history practically *mandates* that it be accounted for in cost-sharing agreements. At the very least, the legislative history confirms that the cost-sharing regulation is a reasonable exercise of Treasury's authority under the commensurate-with-income standard of section 482. If the lack of an appropriate unrelated-party analogue meant that Treasury had no authority to make adjustments, taxpayers could engage without restraint in precisely the sort of manipulation that section 482 was intended to stop.

II. The Tax Court misunderstood and misapplied precedent on judicial review of agency rulemaking procedures.

The Tax Court, however, refused to consider whether the commensurate-with-income authority could justify the regulation. That refusal was based on a basic misunderstanding of administrative law—an error that the court compounded by wrongly faulting Treasury for failing to adequately respond to comments before promulgating the final rule.

A. The Tax Court misapplied *Chenery* and *State Farm* in disregarding Treasury's commensurate-with-income authority as a basis for the cost-sharing regulation.

A single but fatal mistake of administrative law by the Tax Court cascaded into its misdirected analysis of the tax issues. The court determined that, "because Treasury did not rely *exclusively* on the commensurate-with-income standard," it could not "sustain the final rule solely on that basis" if the court determined that "Treasury's reliance on the arm's-length standard in issuing the final rule was unreasonable." ER 59. (emphasis in original).

That is incorrect. The primary case on which the Tax Court relied, the Supreme Court's opinion in *S.E.C. v. Chenery*, provides that a court "must judge the propriety of [an agency action] solely by the grounds invoked by the agency." 332 U.S. 194, 196 (1947). But even though a court "may not supply a reasoned basis for the agency's action that the agency itself has not given," the court should "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983); *see also Bowman Transp., Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 285 (1974). Yet the Tax Court made no effort to determine if there was a reasonably discernable justification for the regulation under Treasury's commensurate-with-income authority—even though Treasury explicitly cited that authority in both the preamble to the final cost-sharing regulation and the notice of

proposed rulemaking.[5] *Chenery* does not stand for the proposition that where an agency supports its action with two separate justifications, the action is invalid unless *each* justification is independently sufficient. Indeed, this Court has held that if an agency's determination can be supported on "*any* rational basis," it must be upheld. *McFarland v. Kempthorne*, 545 F.3d 1106, 1113 (9th Cir. 2008) (emphasis added).

Under a proper understanding of *Chenery* and *State Farm*, the regulation should be upheld. The preamble to the final regulation invokes the commensurate-with-income authority as a sufficient independent basis for the cost-sharing rule. It states that that the final rule is "consistent with the legislative intent underlying section 482" in that "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.'" 68 Fed. Reg. at 51,172. By quoting the legislative history connected to the addition of the commensurate-with-income standard to section 482, the preamble makes clear that

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[5] The Tax Court has rarely dealt with this area of administrative law. Prior to the Supreme Court's opinion in *Mayo Foundation for Medical Educ. & Research v. U.S.*, 562 U.S. 44 (2011), the Tax Court had cited *Chenery* a total of just four times. Tax Court opinions have cited *State Farm* just nine times ever (excluding *Altera*). This case is the first appellate review of the Tax Court's application of *Chenery*.

the cost-sharing regulation is based on Treasury's commensurate-with-income authority, a fact ignored by the Tax Court, in contravention of *Chenery* and *State Farm*.

The preamble, moreover, is consistent with the original notice of proposed rulemaking. 67 Fed. Reg. 48,997 (proposed July 29, 2002). That notice begins with an explanation of the commensurate-with-income standard and the legislative history supporting application of that standard to cost-sharing arrangements. *Id.* at 48,998. The notice also explains that the regulation is intended to "coordinat[e]" the cost-sharing rules with the arm's-length standard—in other words, that Treasury did not necessarily intend to rely solely on the arm's-length standard. This explanation provided affected parties the opportunity to respond to Treasury's use of its commensurate-with-income authority. But commenters instead focused on the arm's-length standard. Not surprisingly, the preamble thus put more emphasis on the arm's-length standard in responding to comments. But that is not a basis for the Court to disregard the commensurate-with-income authority as a justification for the regulation.

By failing to consider Treasury's commensurate-with-income authority, the Tax Court also failed to see that the preamble establishes that the cost-sharing regulation is grounded in exactly the factors contemplated by Congress, as required under *State Farm*. *See* 5 U.S.C. § 706(2)(A) (providing judicial review for arbitrary

and capricious agency action). *State Farm* requires that the agency "articulate a satisfactory explanation for its action," and provide a basis for the court to determine that "the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." 463 U.S. at 43. The "relevant factors" are those that Congress "intended it to consider." *Id.*

Here, Congress had a specific understanding of how "actual economic activity" should be measured in cost-sharing agreements: The legislative history accompanying the commensurate-with-income amendment emphasized that an appropriate proxy for such activity is "all research and development costs." H.R. Rep. No. 99-841 at II-638; 68 Fed. Reg. at 51,172. That is exactly the approach that Treasury adopted in the cost-sharing regulation, even directly referencing the legislative history in the preamble. 68 Fed. Reg. at 51,172.

Beyond that, Treasury also responded to the very concern that prompted Congress to add the commensurate-with-income authority in the first place. After commenters claimed that cost-sharing agreements between unrelated parties do not account for stock-based compensation, citing examples purporting to bear this out, Treasury responded to this evidence in the preamble by explaining: "The uncontrolled transactions cited by commentators do not share enough characteristics of [cost-sharing agreements under the regulation] 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 [cost-sharing agreement under the regulation]." 68 Fed. Reg. at 51,173. This statement echoes the legislative history that accompanied the addition of commensurate-with-income authority to section 482: Congress stated that the purpose of this authority was to address transactions involving intangible property for which comparable unrelated-party transactions are not available or are not reliable. Treasury's response perfectly aligns with this purpose.

Treasury's response also identifies a fundamental issue with stock-based compensation in cost-sharing agreements between unrelated parties: The economics are entirely different than in an agreement between related parties. Expressly citing "the legislative history of the Tax Reform Act of 1986," the preamble notes that "there is little, if any, public data regarding transactions involving high-profit intangibles." *Id.* (citing H.R. Rep. No. 99-426, at 423-25). Even the data presented by commenters did not involve high-value intangibles, thus illustrating the challenge of relying on actual uncontrolled transactions in this context. Altera itself provides an instructive example: Given that its business model is premised on its R&D activities producing new high-value intangibles year after year (for example, new designs for the programmable logic devices that are Altera's core product), it would make no business sense for Altera to enter into a cost-

sharing agreement to surrender proceeds from exploiting those intangibles to an unrelated party.

The Tax Court distorted Treasury's reasoning in the preamble by taking one sentence out of context, and disregarding an entire section of the preamble responding to critiques of the arm's-length standard. Under the header "Comments Relating to Arm's Length Standard," Treasury explained that accounting for stock-based compensation in cost-sharing agreements is justified under the commensurate-with-income standard, which is *consistent with* the arm's-length standard. *Id*. at 51,172. But in casting the preamble as relying on the arm's-length standard, the Tax Court focused on a comment response further down, appearing under the header "Other Comments," rather than in the section that directly addresses concerns about use of the arm's-length standard. There, the preamble states: "The final regulations provide that stock-based compensation must be taken into account in the context of [cost-sharing agreements under the regulation] because such a result is consistent with the arm's length standard." *Id.* at 51,173. The Tax Court takes this to mean that Treasury is relying on the arm's-length standard. But read *in context*, rather than out of context, this statement does not mean that the commensurate-with-income standard is an insufficient independent basis for the final rule.

This Court has explained that, in undertaking an "analysis of whether an agency's action was arbitrary or capricious, we are required to be 'highly deferential, presuming the agency action to be valid.'" *Providence Yakima Med. Ctr. v. Sebelius*, 611 F.3d 1181, 1190 (9th Cir. 2010). The Tax Court failed to provide such deference. Had the court started from the presumption of validity, as this Court requires, it would have concluded that the preamble justifies the cost-sharing regulation in language that independently relies on the commensurate-with-income standard, and hence that Treasury's "path may reasonably be discerned." *State Farm*, 463 U.S. at 43. By disregarding Treasury's authority under this standard—and by ignoring the preamble's explanation of the cost-sharing regulation in terms of the factors clearly intended by Congress—the Tax Court committed reversible error.

B. Treasury adequately responded to comments claiming that stock-based compensation does not constitute a real economic cost.

The Tax Court also erred by wrongly faulting Treasury for failing to respond adequately to comments on the proposed rule regarding supposedly comparable unrelated-party transactions (addressed above) and whether stock-based compensation is a real economic cost to employers. An agency is required to "respond to significant comments, *i.e.* those which raise relevant points and which, if adopted, would require a change in the agencies proposed rule." *Am. Mining*

Congress v. U.S. E.P.A., 965 F.2d 759, 771 (9th Cir. 1992) (internal quotation marks omitted); *see also Safari Aviation Inc. v. Garvey*, 300 F.3d 1144, 1150-51 (9th Cir. 2002). But the "failure to respond to comments is grounds for reversal only if it reveals that the agency's decision was not based on consideration of the relevant factors." *Am. Mining Congress*, 965 F.2d at 771. Treasury provided a sufficient response in the preamble to comments that stock-based compensation is not a real economic cost, and its position has subsequently been vindicated.

Commenters claimed that stock-based compensation is not a real economic cost to employers and presented academic opinions supporting this proposition. One professor submitted comments at the request of Xilinx, Inc. (a taxpayer situated similarly to Altera) stating that stock options have "no effect on a firm's operating expenses as that term is generally understood." Joseph A. Grundfest, *Comment Letter on Proposed Treas. Reg. 1.482-7 Regarding Compensatory Stock Options* (Oct. 30, 2002). Similarly, a report by economists William Baumol and Burton Malkiel, submitted by a trade group, questioned whether stock options constitute an "economic cost" to the firms, pointing to analytical challenges in valuing stock options and measuring their costs. Software Finance and Tax Executives Counsel, *Comment Letter on Proposed Rulemaking Regarding Compensatory Stock Options Under Section 482* (Nov. 5, 2002).

The preamble to the final cost-sharing regulation responds to these comments. It says that, where two unrelated parties negotiate a cost-sharing agreement, if a "significant element" of 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." 68 Fed. Reg. at 51,173. The regulation then provides alternative methods for measuring costs, extending flexibility for taxpayers, and reflecting the analytical challenges the commenters noted. *See* 26 C.F.R. 1.482-7A(d)(2)(iii)(A), (B). This reasonable—even generous—response provided more than enough justification for the regulation.

Additionally, the Code provides general rules to measure stock-based compensation for purposes of allowing a deduction for such costs, belying the contention that stock-based compensation is unmeasurable. *See* 26 U.S.C. §§ 83, 421, 422. These rules are the basis for calculating taxable income for employers and employees outside of the related-party context to which section 482 applies. The cost-sharing regulation cites these Code provisions. *See* 26 C.F.R. 1.482-7A(d)(2)(i), (iii) (citing 26 U.S.C. § 83). And the cost-sharing regulation reflects these general rules by providing that "the operating expense attributable to stock-based compensation is equal to the amount allowable … as a deduction for Federal income tax purposes … (for example, under section 83(h))." *Id.* § 1.482-

7A(d)(2)(iii)(A). In short, the cost-sharing regulation uses existing income-tax rules to calculate appropriate payments under cost-sharing agreements between related parties so as to reflect the "actual economic activity" undertaken by the parties.

Now that stock-based compensation is accounted for in financial statements, we know that at many technology companies stock-based compensation expenses amount to 5% or more of annual revenue.[6] Andrew Barry, *How Much Do Silicon Valley Firms Really Earn?*, Barron's, June 27, 2015, http://goo.gl/AGcMP8. Recent data indicates that 20-25% of compensation for engineers at Google, for instance, is stock-based compensation. Phil Johnson, *Man or Myth: The $3 million Google engineer*, IT World Jan. 14, 2014, http://goo.gl/UJJsEl. And for executives, stock-based compensation can be many multiples of cash compensation. Barry, *Silicon Valley Firms*.

The fact that stock-based compensation is an actual economic cost is confirmed by Altera's own filings with the Securities and Exchange Commission. In 2005, Altera adopted an equity incentive plan that provided for payments of stock options, restricted stock, restricted stock units, and stock appreciation rights. Altera Corp., Proxy Statement (Form DEF 14A) A-1 (Apr. 7, 2005),

[6] Since 2005, companies have been required to report stock-based compensation as an expense on financial accounting statements of income (now under Accounting Standards Codification 718), which, along with the pre-2005 rules, undercuts any claim that stock-based compensation is not an actual cost. *See* Gov't Br. 15 (describing financial accounting requirements prior to 2005).

https://goo.gl/N57iGE. This plan thus allowed for a variety of stock-based compensation, all of which the Code addresses outside of the transfer-pricing context, and all of which are familiar to Treasury and the IRS as measurable costs that must be accounted for in calculating taxable income.[7] According to Altera's most recent annual report, its stock-based compensation cost was 4.98% of its total revenue ($96.4 million of $1.932 billion). Altera Corp., Annual Report for the Fiscal Year Ended Dec. 31, 2014 (Form 10-K) (Feb. 13, 2015), https://goo.gl/KGFrTi.

Further, in 2005, Altera's proxy statement stated that the "use of stock options has long been a vital component of Altera's overall compensation philosophy," and that, "without stock options or another form of equity compensation, *Altera would be forced to consider cash alternatives to provide a market-competitive total compensation package*." Altera Proxy Statement (Form DEF 14A), at 26 (emphasis added). In other words: Altera itself considered stock-based compensation a substitute for cash compensation in the relevant time period. Treasury did not act unreasonably in reaching the same conclusion.

[7] Notably, some of the variations of stock-based compensation that Altera uses are convertible to cash payments. *Id.* at A-5. This underscores that the cost of stock-based compensation is calculable, while also presenting an avenue for further manipulation by taxpayers: If the cost pool need not include stock-based compensation, taxpayers could potentially exclude from the cost pool compensation that is convertible to (and payable in) cash simply by calculating it by reference to shares.

III. Even if this Court were to find that Treasury's explanation for the cost-sharing regulation is inadequate, the regulation should be sustained.

A. Because the cost-sharing regulation is substantively reasonable, any error by Treasury was harmless.

If this Court finds that Treasury did not adequately explain the basis for the cost-sharing regulation, that failure does not justify the drastic step of invalidating the regulation. *See* 5 U.S.C. § 706 ("due account shall be taken of the rule of prejudicial error"). This Court will sustain an agency's regulation if any mistake by the agency "clearly had no bearing on the procedure used or the substance of the decision reached." *Cal. Wilderness Coal. v. U.S. Dep't of Energy*, 631 F.3d 1072, 1090 (9th Cir. 2011) (internal quotation marks omitted). And the "burden of showing that an error is harmful normally falls upon the party attacking the agency's decision." *Shinseki v. Sanders*, 556 U.S. 396, 409 (2009). Under that standard, Altera must show that "had it been provided the process it was due, it could have, and plausibly would have," used that process to alter the result. *Al Haramain Islamic Found., Inc. v. U.S. Dept. of Treasury*, 686 F.3d 965, 989 (9th Cir. 2011). Where the agency "would have arrived at the same determination," even with the missing process in place, "any error is harmless." *Id.* at 989 n.16.

Altera has not carried its burden. It has not shown that the asserted error—Treasury's explanation of the final rule, in light of the comments it received—had any "bearing on the procedure used," *Cal. Wilderness Coal.*, 631 F.3d at 1090. To

the contrary, Treasury followed the required notice-and-comment process and responded appropriately to the comments received. Nor has Altera shown that Treasury would have reached a different conclusion had it determined that, as an empirical matter, unrelated companies do not include stock options as costs in similar agreements. To the contrary, Treasury considered the evidence and concluded that *comparable* unrelated party transactions are not available in this context. That conclusion is not only substantively reasonable, it squarely addresses the concerns that led Congress to create the commensurate-with-income standard in the first place.

B. At a minimum, this Court should remand the regulation to Treasury without vacating it, so that Treasury can clarify its explanation.

At a minimum, this Court should leave in place the regulation and give Treasury the opportunity to clarify its explanation. This Court has stated that, "when equity demands," a regulation "can be left in place while the agency follows the necessary procedures." *Idaho Farm Bureau Federation v. Babbitt*, 58 F.3d 1392, 1405 (9th Cir. 1995). This Court has left regulations in place even when "reenactment of the deliberative process" on remand to the agency might change the substantive outcome. *W. Oil & Gas Ass'n v. EPA*, 633 F.2d 803, 813 (9th Cir. 1980). The Administrative Conference of the United States recently recommended the continued use of remand without vacatur, finding it to be consistent with

section 706(2) of the Administrative Procedure Act. Administrative Conference of the U.S., Recommendation 2013-6: Remand Without Vacatur, 2013 ACUS 3.

In a similar context, this Court left a challenged rule in effect while remanding to the agency for further consideration, explaining that "[o]ur intervention into the process of environmental regulation, a process of great complexity, should be accomplished with as little intrusiveness as feasible." *W. Oil & Gas*, 633 F.2d at 813. The same is true here: Transfer pricing and the regulations under section 482 are highly complex, and the calibration of particular transfer-pricing methods should, to the extent permissible under Congress's delegation to Treasury, be accomplished with as little disruption by the courts as is feasible. Treasury should at least have an opportunity to justify the cost-sharing regulation more clearly under the commensurate-with-income standard before this Court wipes the regulation off the books.

IV. The policy implications of affirming the decision below would be significant.

If this Court were to affirm the Tax Court's decision, the potential effects on tax administration would be significant. There is a long and important regulatory tradition of Treasury providing thorough and *explanatory* guidance documents on tax matters, including notices of proposed rulemaking and preambles to final rules. Tax practitioners regularly look to, and rely on, these documents (particularly preambles) to explain Treasury's intent and the policy considerations behind a

regulation. The Tax Court's decision could transform preambles into defensive, litigation-oriented documents, which would limit their utility to taxpayers.

Vacating the cost-sharing regulation would reduce federal revenues by billions of dollars. *See* Richard Rubin, *Google's Parent Could be Big Winner in Intel Tax Dispute*, Wall Street Journal, Feb. 29, 2016, http://goo.gl/h1R3FH (stating that Google alone has $3.5 billion at stake). But the spillover effects would, in all likelihood, be dramatically larger. The section 482 regulation regarding shared services also invokes "all costs," 26 C.F.R. § 1.482-9, and we believe that taxpayers would feel emboldened to exclude stock-based compensation from those cost pools as well, at even greater cost to the public fisc.

The effects would not end there. Virtually every existing tax regulation could be challenged on procedural grounds. Denying Treasury the opportunity to correct any errors could thus unsettle and undermine many important substantive tax rules, including the entire section-482 regulatory framework and innumerable other tax regulations. Even if courts ultimately were to uphold the substance of challenged regulations, hundreds of billions or trillions of dollars of revenue would be at stake as taxpayers took positions presuming that regulations would be challenged and potentially vacated on procedural grounds. *See* Gov't Br. 24-25 (describing Altera anticipating in 2005 that courts may not uphold the cost-sharing regulation, and hence not including stock-based compensation costs on that basis).

Rather than bring about these undesirable consequences, we urge the Court to uphold the cost-sharing regulation as a reasonable exercise of Treasury's statutory authority.

CONCLUSION

The Tax Court's judgment should be reversed.

Respectfully submitted,

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STATEMENT OF RELATED CASES

To the best of my knowledge, there are no related cases.

s/ Jonathan E. Taylor
Jonathan E. Taylor

CERTIFICATE OF COMPLIANCE

I hereby certify that my word processing program, Microsoft Word, counted 6,992 words in the foregoing brief, exclusive of the portions excluded by Rule 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because it was prepared in 14-point Baskerville font.

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CERTIFICATE OF SERVICE

I hereby certify that on July 7, 2016, I electronically filed the foregoing Brief of 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, in Support of Appellant with the Clerk of the Court of the U.S. Court of Appeals for the Ninth Circuit by using the Appellate CM/ECF system. All participants are registered CM/ECF users, and will be served by the Appellate CM/ECF system.

s/ Jonathan E. Taylor
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