No. 16-70496 and No. 16-70497

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

BRIEF OF AMICUS CURIAE AMAZON.COM, INC. IN SUPPORT OF PETITIONER-APPELLEE AND AFFIRMANCE

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CORPORATE DISCLOSURE STATEMENT

No parent corporation or any publicly held corporation owns 10% or more of the stock of Amicus Curiae, Amazon.com, Inc.

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IDENTITY AND INTEREST OF AMICUS CURIAE

Amicus Curiae, Amazon.com, Inc. ("Amazon"), is a Delaware corporation with its principal address in Seattle, Washington. Amazon files this brief with the consent of all parties.

Like Altera, Amazon participated in a qualified cost sharing arrangement under Treasury Regulation section 1.482-7A (1995). Amazon currently has a case pending in the Tax Court, Docket No. 31197-12 (appealable to this Court), seeking redetermination of the Commissioner's adjustments to various aspects of Amazon's qualified cost sharing arrangement. Like Altera, one of the issues presented in Amazon's Tax Court case is whether stock-based compensation must be included when computing the costs shared in a qualified cost sharing arrangement under Treasury Regulation section 1.482-7A. Amazon's Tax Court case also involves other issues under Treasury Regulation section 1.482-7A, including the proper determination of the so-called "buy-in" payment required with respect to pre-existing intangible property and the proper determination of the intangible development costs to be shared.

STATEMENT OF AUTHORSHIP AND FUNDING OF BRIEF

No party's counsel authored any portion of this brief, in whole or in part. No person or entity other than Amazon has or is expected to contribute money intended to fund preparing or submitting this brief.

BACKGROUND

Section 482 of the Internal Revenue Code[1] grants the United States Department of the Treasury ("Treasury") discretionary authority to reallocate income among controlled taxpayers. In 2003, Treasury issued final regulations pursuant to section 482 requiring taxpayers that participate in a "qualified cost sharing arrangement" (a "QCSA") under Treasury Regulation section 1.482-7A (including taxpayers who had previously entered into a QCSA) to share stock-based compensation as intangible development costs (the "SBC Requirement"). *See* Treas. Reg. § 1.482-7A(d)(2). In a unanimous, reviewed opinion, the Tax Court held that the SBC Requirement was an invalid exercise of the authority granted to Treasury by section 482. *See Altera Corp. v. Commissioner*, 145 T.C. 91, 132-34 (2015).

The Tax Court specifically held that the SBC Requirement is invalid under section 706(2)(A) of the Administrative Procedure Act[2] for failing to satisfy the reasoned decision-making standard of *Motor*

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[1] All "section" references herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury Department regulations ("Treasury Regulations") promulgated thereunder.

[2] 5 U.S.C. § 706.

Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983). *See Altera*, 145 T.C. at 132-34. The Tax Court also held that the second step of an analysis under *Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984), incorporates *State Farm*'s reasoned decision-making standard, and that, as a result, invalidity under *State Farm* would constitute invalidity under *Chevron*. *See Altera*, 145 T.C. at 133-34, n.29.

SUMMARY OF ARGUMENT

Amazon agrees with the Tax Court and submits this brief to make two additional points.

First, amici in support of the Commissioner are incorrect to suggest that Treasury may impose the non-arm's-length SBC Requirement simply because the overall QCSA regime is a safe harbor. In the rulemaking process, Treasury expressly disavowed any safe harbor-based justification for departing from the arm's-length standard. Likewise, the Commissioner has not advanced any such argument in this appeal. Accordingly, the Court should not entertain any such post-hoc justifications for the SBC Requirement.

Second, even if the QCSA regime had been stipulated by the parties as a safe harbor or was properly raised as an issue before this Court, the SBC Requirement would nevertheless be invalid. Consistent with this Court's precedent, Treasury cannot issue regulations under section 482 that *require* taxpayers to report income on a non-arm's-length basis simply by embedding such a provision as a condition to participating in a safe harbor. Therefore, amici's statements implying that Treasury may impose non-arm's-length results if it acts through a safe harbor are wrong.

ARGUMENT

The SBC Requirement was not added as an independent safe harbor, but as a condition to the overall safe harbor QCSA regime.[3] Amici for the Commissioner raise the QCSA safe harbor characterization, suggesting that it justifies the SBC Requirement. *See* Brief for Alstott, et al. as Amici Curiae Supporting Respondent-Appellant at 13, *Altera Corp. v. Commissioner*, Nos. 16-70496, 16-70497 (9th Cir. July 7, 2016); Brief for Harvey, et al. as Amici Curiae Supporting Respondent-Appellant at 5, *Altera Corp. v. Commissioner*, Nos. 16-70496, 16-70497 (9th Cir. July 1, 2016). But because Treasury did not advance this issue during the rulemaking process and the Commissioner has not raised it in this appeal, any safe harbor-based argument in support of the SBC Requirement must be rejected. Moreover, as explained in section III, *infra*, although Treasury may issue safe-harbor regulations under section 482, it cannot impose upon

[3] In Amazon's case currently pending in the Tax Court, Amazon has similarly noted that Treasury Regulation section 1.482-7A provides taxpayers with a safe harbor that limits the Commissioner's ability to impose section 482 adjustments.

taxpayers a non-arm's-length reallocation of income—the SBC Requirement—simply by embedding it as a condition of the safe harbor.

I. The Status of the Overall QCSA Regime As a Safe Harbor Does Not Permit Treasury to Impose Non-Arm's-Length Results through the SBC Requirement

Section 482 grants Treasury broad discretion to reallocate income among controlled taxpayers to reach an arm's-length result, providing that the Secretary "*may* distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" controlled taxpayers "if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income . . . ." (emphasis added); *see, e.g.*, *Gulf Oil v. Commissioner*, 87 T.C. 548, 565 n.2 (1986) ("[A] requirement that the Commissioner use sec. 482 . . . would improperly impinge on the discretion of the Commissioner."); *DHL Corp. v. Commissioner*, 285 F.3d 1210, 1216 (9th Cir. 2002) ("The Commissioner has broad discretion under section 482").

Pursuant to this authority, Treasury *may* (but is not required to) exercise its authority to adjust the tax results of transactions between controlled taxpayers to reflect arm's-length results. Because section

482 is discretionary, it permits Treasury to establish the circumstances under which it will or will not adjust taxpayer income. Thus, as it did with the broader QCSA regime, Treasury may provide that it will not adjust taxpayer income if the relevant transactions fall within certain, defined circumstances, even though such circumstances may not produce arm's-length results in all cases. In other words, Treasury is permitted to limit its statutory discretion in specific circumstances by creating regulatory safe harbors under section 482. But in no event can Treasury exercise its discretion to compel, directly or indirectly, results that are not arm's-length.

In 1995, Treasury exercised this authority by issuing regulations establishing the QCSA regime. *See Section 482 Cost Sharing Regulations*, 60 Fed. Reg. 65,553, 65,555 (Dec. 20, 1995). These regulations were a reformulation of the cost sharing safe harbor that existed under the prior 1968 regulations.[4] The preamble to the 1995

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[4] As the IRS has recognized, regulations under section 482 had provided a safe harbor for cost sharing arrangements since 1968. In published field advice, the IRS noted:

> The [1968] regulations under section 482 provide guidance in determining an arm's-length charge for intercompany loans, services, rentals of tangible property, transfers or licenses of

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regulations describes cost-sharing as a "safe harbor" *four times*, including twice in the general description of the regulations:

> Section 1.482-7(a)(1) defines a cost sharing arrangement as an agreement for sharing costs in proportion to reasonably anticipated benefits from the individual exploitation of interests in the intangibles that are developed. In order to claim the benefits of the ***safe harbor***, a taxpayer must also satisfy certain formal requirements (enumerated in § 1.482-7(b)). The district director may apply the cost sharing rules to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding any failure to satisfy particular requirements of the ***safe harbor***.

60 Fed. Reg. at 65,555 (emphasis added).

Further, the QCSA regime operates as a safe harbor. A taxpayer elects the QCSA safe harbor by adopting an arrangement satisfying the substantive and procedural requirements set forth in the QCSA regulations, as opposed to adopting other arrangements for the development and exploitation of intangible property, which would be governed by the general rules under Treasury Regulation section 1.482-4. The regulations declare that taxpayer compliance with the QCSA

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> intangible property and transfers of tangible property. The cost sharing rules of Treas. Reg. § 1.482-2(d)(4) offer a safe harbor from the intangible transfer rules.

I.R.S. Field Serv. Adv., 1997 WL 33107193, at *4 (Feb. 21, 1997) (emphasis added).

regime will be treated by the Commissioner as satisfying arm's-length principles without any further evidentiary showings by the taxpayer:

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

Treas. Reg. § 1.482-7A(a)(3).[5] Correspondingly, Treasury eliminates the Commissioner's ability to adjust taxpayers with respect to the development and exploitation of intangibles under a QCSA other than to ensure that the taxpayer shares costs in proportion to reasonably anticipated benefits. *See* Treas. Reg. § 1.482-7A(a)(2) (entitled "[l]imitation on allocations" and limiting the Commissioner's discretion solely to ensuring that each cost-sharing participant's intangible development costs are in proportion to its reasonably anticipated benefits).

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[5] This regulation, however, cannot permit Treasury to require taxpayers to report non-arm's-length results in contravention of the authorizing statute (section 482) and, consequently, this coordinating regulation cannot convert a patently non-arm's-length requirement—the SBC Requirement—into an arm's-length result, as suggested by the Commissioner. Appellant Br. 30.

The combination of deeming compliance with the QCSA rules to satisfy the arm's-length standard and promising to refrain from making adjustments other than to ensure that costs are shared in the required proportions creates a safe harbor. The QCSA rules thus reflect the exercise of the Commissioner's discretion to refrain from adjusting taxpayer income or attributes under section 482 in prescribed circumstances.

When Treasury proposed new cost sharing regulations in 2005—ten years after the 1995 regulations governing this case—it stated that the new regulations were intended to "dispel the misconception" that cost sharing is a safe harbor. *See Section 482: Methods to Determine Taxable Income in Connection with a Cost Sharing Agreement*, 70 Fed. Reg. 51,116, 51,127-28 (Aug. 29, 2005). Treasury did not, however, square this pronouncement with its own, plainly stated declaration that the 1995 regulations created a safe harbor. Instead, it promulgated new rules that were widely acknowledged as a significant departure from the 1995 regulations.[6] Even the IRS considered the new

[6] *See* ABA Tax Sec., Comments on Proposed Regulations for Cost Sharing Arrangements at 4 (Dec. 4, 2006) (describing the 2005 Proposed

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regulations a "comprehensive rewrite."[7] Thus, Treasury's statement must be read to mean that it intended to pass new regulations that did not provide taxpayers with a safe harbor.

Treasury could not have intended these statements in 2005 to mean that the earlier QCSA regulations *did not* establish a safe harbor, given its express statements to the contrary in the 1995 preamble and elsewhere. Any such implication would fail to provide taxpayers with "clear, fair notice of how the regulations will affect them." *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191, 1198 (9th Cir. 2010) (Fisher, J., concurring). Treasury cannot disavow its own rules after-the-fact and is instead bound by these rules and published statements.

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Cost-Sharing Regulations as "the total revocation and replacement of the existing cost sharing regulations"); ABA Tax Sec., Comments on Temporary Cost Sharing Regulations at 1, 3 (June 3, 2009) (noting that the 2005 Proposed Cost-Sharing Regulations "introduced new transfer pricing methods, concepts, and new terminology," and that the 2009 Temporary Cost-Sharing Regulations "contain a new paradigm for conceptualizing the contributions of the parties," among other changes).

[7] IRS Issues Directive on Cost Sharing Arrangements (LMSB-04-0307-027, Apr. 5, 2007).

II. Treasury Did Not Justify the SBC Requirement on Any Safe Harbor Grounds During the Rulemaking Process, the Commissioner Did Not Advance Any Such Argument on Appeal, and this Court Should Not Countenance Any Such Argument Presented by Amici

Treasury did not justify its adoption of the SBC Requirement on the fact that the QCSA regulations provide a safe harbor and, even if it had, the Commissioner has abandoned that issue on appeal.[8] The validity of the SBC regulation must be evaluated based on the justifications offered by the Treasury during the rulemaking process, and not on post-hoc theories obliquely posited by amici in support of the Commissioner in this case.

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[8] Focusing solely on the SBC Requirement before it that was promulgated on a stand-alone basis in 2003, the Tax Court noted that "Respondent also argue[d] that petitioner cannot complain if the final rule sometimes produces results that are inconsistent with the arm's-length standard because the QCSA regime provides an 'elective assured treatment.'" *Altera Corp. v. Commissioner*, 145 T.C. 91, 126 n.21 (2015). The Tax Court disposed of this argument by stating "Treasury rejected commentators' suggestion to issue the final [SBC Requirement] rule as a safe harbor and we conclude that petitioner has not forfeited its right to challenge the validity of the final [SBC Requirement] rule because it chose to structure the R&D cost-sharing agreement as a QCSA." *Id.* The Tax Court's conclusion does not address whether or not the overall QCSA regime, initially promulgated in 1995, was a "safe harbor" but rather correctly concludes the SBC Requirement was a required condition of electing into the QCSA regime more generally, commencing in 2003. The Tax Court's conclusion is also consistent with case law such as *Rite Aid*, *infra* section III, which provides that

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Treasury justified the SBC Requirement on the basis that it believed it produced arm's-length results and not on the basis that it was part of the overall QCSA safe harbor. In the preamble to the 2003 rulemaking, Treasury stated that "Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard . . . ." *Compensatory Stock Options Under Section 482*, 68 Fed. Reg. 51,171, 51,172 (Aug. 26, 2003). Treasury further stated that "[t]he final regulations therefore require employee compensation [including stock-based compensation] to be taken into account, rather than provide for a safe harbor under which such compensation could be ignored." *Id.* at 51,174; *see also* Appellee Br. 55 n.18 (noting that the SBC Requirement was not a safe harbor).

Treasury's actions cannot now be salvaged by a post-hoc justification for its rulemaking that is completely at odds with its contemporaneous bases for establishing the regime. *See SEC v.*

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Treasury cannot exceed its statutory grant of authority even when promulgating an elective regime or safe harbor.

Chenery Corp., 318 U.S. 80 (1943) (holding agency decisions must be evaluated on the basis of the rationale offered at the time of the rulemaking and not based upon ad-hoc, after-the-fact justifications). Similarly, amici may not inject a post-hoc rationalization for the SBC Requirement in this case when the Commissioner has not advanced any such argument in this appeal. *See, e.g.*, *Swan v. Peterson*, 6 F.3d 1373, 1383 (9th Cir. 1993) ("Generally, we do not consider on appeal an issue raised only by an amicus."); *Sanchez–Trujillo v. INS*, 801 F.2d 1571, 1581 n.9 (9th Cir. 1986) (amicus may not frame the issues for appeal); *Preservation Coalition, Inc. v. Pierce*, 667 F.2d 851, 862 (9th Cir. 1982) ("Had [petitioner] wished to preserve this issue on appeal, it could easily have done so. It did not. Consequently, it has waived the issue.").

III. This Court Should Reject any Defense of the SBC Requirement Based on a "Safe Harbor" Argument

Even if Treasury had consistently justified the SBC Requirement as part of an elective safe-harbor regime, the regulation would still be invalid because it seeks to impose upon taxpayers a non-arm's-length condition, which is wholly at odds with the statutory requirements of section 482. A statute enacted to permit Treasury to require arm's-length treatment cannot be used by Treasury to impose the very opposite result.

A. The Commissioner Cannot Impose Non-Arm's-Length Reallocations under Section 482

This Court has previously established in *Xilinx* that the Commissioner cannot, by exercise of his statutory discretion, impose non-arm's-length reallocations of income on taxpayers under section 482. At issue in *Xilinx* was an apparent conflict between the then applicable regulations in sections 1.482-1(b)(1), which defines the arm's-length standard, and 1.482-7A(d)(1), which required the inclusion of "all costs" in the cost pool of a QCSA. The conflict was created by the Commissioner's argument that the "all costs" mandate extended to stock-based compensation even though, as the Commissioner did not dispute, the Tax Court found that parties operating at arm's-length would *not* share such costs. Thus, in *Xilinx*, the Commissioner attempted to interpret section 482 and apply the QCSA safe harbor rules to require taxpayers to report non-arm's-length results in violation of section 482.

This Court in *Xilinx* rejected the Commissioner's arguments, resolving the apparent regulatory conflict by looking to the purposes and statutory bounds of section 482. The Court made clear that when Treasury exercises its discretionary authority under section 482 to reallocate income, it must do so within the limits of the arm's-length standard.

B. Treasury Has Discretion Under Section 482 to Issue Safe-Harbor Regulations

Although *Xilinx* requires Treasury to comply with the arm's-length standard when it affirmatively asserts reallocations under section 482, nothing in the *Xilinx* decision limits Treasury's broad discretion to abstain from exercising its authority under section 482. In this sense, section 482 operates as a one-way street: the reallocation authority is a unilateral authority belonging to Treasury, and not to taxpayers. In exercising this authority, Treasury can *permit* non-arm's-length results but cannot *impose*, directly or indirectly, non-arm's-length results.

This "one-way" nature of section 482 is evident in the guidance issued under section 482. For example, the regulations under section 482 contain several safe harbors upon which Treasury has permitted taxpayers to rely without any threat of reallocation by the Commissioner, demonstrating that Treasury may choose not to regulate to the full extent of its authority. *See, e.g.*, Treas. Reg. § 1.482-2(a)(2)(iii) (permitting taxpayers that transact in certain intercompany loans to use "safe haven" interest rates for such loans). Section 482, itself, authorizes only the Treasury to act and impose arm's-length results; it does not directly require that taxpayers report income on an arm's-length basis.[9]

When Treasury has defined the circumstances in which it will *not* exercise its discretionary authority under section 482 (such as by promulgating regulatory safe harbors), taxpayers may rely on such self-imposed, published limitations on the Commissioner's discretion. For example, in *Woods Investment,* the Tax Court considered whether the IRS was bound by Treasury's regulation under section 1502 that, in certain circumstances, resulted in a "double deduction" for taxpayers electing to file consolidated returns. The Tax Court held that it would apply the regulations "as written," and that if the Commissioner believed that the taxpayer erroneously received a "double deduction"

[9] Indeed, Treasury does not permit taxpayers to file amended returns to correct the pricing of controlled transactions in an income-reducing direction, even if such amended returns are necessary to reflect an arm's-length result, demonstrating that the section 482 reallocation authority is Treasury's alone. Treas. Reg. § 1.482-1(a)(3).

contrary to the clear-reflection-of-income purposes of section 1502, then the Government's remedy was to "use his broad power to amend his regulations." *Woods Inv. Co. v. Commissioner*, 85 T.C. 276, 282 (1985).[10] The Supreme Court and other courts have applied this principle both within the consolidated return regime and elsewhere.[11]

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[10] Underlying this principle is the concept of notice which was emphasized by Judge Fisher in his *Xilinx* concurrence as his "*particular reasons* for rejecting the Commissioner's position . . . ." *Xilinx*, 598 F.3d at 1198 (Fisher, J., concurring) (emphasis added). Judge Fisher stated that "taxpayers have not been given clear, fair notice of how the regulations will affect them." *Id.* In reaching this conclusion, Judge Fisher considered "the understanding of corporate taxpayers in similar circumstances" by observing that amicus established that Xilinx's understanding of the regulation was "widely shared in the business community and tax profession." *Id.* at n.2.

[11] *See, e.g.*, *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 838 (2001) (holding Treasury to a strict interpretation of its regulations promulgated under section 1502 despite the government's argument that such an interpretation would lead to significant tax abuses because "Treasury could exercise the authority provided by the Code, 26 U.S.C. section 1502, and amend the consolidated return regulations."); *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398, 411 (1994), *aff'd per curiam*, 62 F.3d 136 (5th Cir. 1995) (stating that Treasury's policy concerns created by the relevant consolidated return regulations are "a problem of respondent's own making"); *Estate of Shapiro v. Commissioner*, 111 F.3d 1010, 1018 (2d Cir. 1997) (explaining, "an abuse of discretion can occur where the Commissioner fails to observe self-imposed limits upon the exercise of his discretion, provided he has invited reliance upon such limitations" (citation omitted)).

C. Treasury Cannot Impose Non-Arm's-Length Results by Establishing them as a Condition to a Safe Harbor

Although Treasury can issue safe-harbor regulations under section 482, Treasury cannot impose upon taxpayers the non-arm's-length adjustment that this Court rejected in *Xilinx* simply by embedding it as a condition of the safe harbor. Other courts have held in a closely analogous context that, even when creating an elective regime (such as the QCSA regime), Treasury may not exceed the boundaries established by Congress in the relevant authorizing statute.

For example, in *Rite Aid*, the Federal Circuit considered whether a regulation forbidding a corporation that elected to file a consolidated tax return from claiming certain losses exceeded the broad authority granted by section 1502. *See Rite Aid Corp. v. United States*, 255 F.3d 1357, 1360 (Fed. Cir. 2001); Treas. Reg. § 1.1502-75(a), (b), (h) (describing the filing of a consolidated return under section 1502 as a "privilege"). At issue in *Rite Aid* was Treasury Regulation section 1.1502-20, which prohibited a corporation electing to file its taxes on a consolidated basis from claiming certain shareholder-level losses that would have been fully allowable had the corporation not filed on a consolidated basis. *Rite Aid*, 255 F.3d at 1358. The Government argued that "filing a consolidated tax return is a privilege, and if the affiliated group elects to take advantage of the benefits of filing a consolidated return, 'it must take the bitter with the sweet.'" *Id.* at 1360 (*quoting Garvey, Inc. v. United States*, 726 F.2d 1569, 1571 (Fed. Cir. 1984)).[12]

The Federal Circuit rejected the Commissioner's argument, holding that "[t]he bitter with the sweet does not include the invalid." *Rite Aid*, 255 F.3d at 1360. The court began its analysis by observing that "[i]ncome tax liability is not imposed by the Secretary's regulations, but by the Internal Revenue Code." *Id.* at 1359 (quoting *Am. Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979)). Proceeding under this foundational principle, the court then consulted the scope of authority granted in the statute, which provided Treasury

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[12] In *Garvey*, the Federal Circuit determined that the regulation at issue, promulgated under the authority granted by section 1502, was permissible even though it altered the taxpayer's tax liability from that which it would have had if it had not filed a consolidated return, noting that taxpayers had to accept "the bitter with the sweet" of the regulations. *Garvey*, 726 F.2d at 1571. *Rite Aid* clarified that the "bitter with the sweet does not include the invalid." *Rite Aid*, 255 F.3d at 1360. The Tax Court has ruled consistently with *Rite Aid*. *See Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790 (1975) (upholding a regulation issued under section 1502 because the taxpayer failed to prove it was inconsistent with section 1502).

broad power "to identify and correct instances of tax avoidance created by the filing of consolidated returns." *Id.* at 1359. The court concluded that the statute "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed" if the taxpayer did not elect to file a consolidated return under section 1502 and instead filed separate returns for each affiliated entity. *Id.* (citing *Am. Standard*, 602 F.2d at 261).

The court concluded that the regulation at issue (1) did not address a problem arising from the consolidated return regime, and (2) distorted rather than "clearly reflect[ed] income" of the consolidated group in contravention of the congressional grant of authority under section 1502. Because the regulation did "not reflect the tax liability of the consolidated group [and was] manifestly contrary to the statute," the court held that the regulation at issue exceeded Treasury's authority and was invalid. *Rite Aid*, 255 F.3d at 1360. In short, while section 1502 granted Treasury broad discretion to impose requirements for participation in an elective regime, those requirements could not exceed the bounds of authority prescribed by Congress.[13] Other predecessor cases to *Rite Aid* adopted a similar approach and reasoning invalidating other regulations under the elective regimes promulgated pursuant to section 1502.[14]

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[13] Following the *Rite Aid* decision, Congress enacted legislation providing that Treasury is permitted under section 1502 to issue regulations providing for different treatment of consolidated and non-consolidated taxpayers. *See American Jobs Creation Act of 2004*, Pub. L. No. 108-357, 118 Stat. 1418, 1600. This legislation did not disturb the analysis or holding of *Rite Aid* in the situation addressed therein. In addition, the legislative history emphasized that Treasury's exercise of its regulatory authority under section 1502 still must comport with the principle of clear reflection of income. *See* H.R. Rep. No. 108-548, pt. 1 (2004); Staff of J. Comm. on Tax'n, 108th Cong., *General Explanation of Tax Legislation Enacted in the 108th Congress* 415 (Comm. Print 2005) ("The Secretary may promulgate consolidated return regulations to change the application of a tax code provision to members of a consolidated group, *provided that such regulations are necessary to clearly reflect the income tax liability* of the group and each corporation in the group, both during and after the period of affiliation.") (emphasis added).

[14] *See Commissioner v. Gen. Mach. Corp.*, 95 F.2d 759, 761 (6th Cir. 1938) (invalidating a consolidated return regulation because it exceeded Treasury's grant of statutory authority, noting "[t]he authority of the Commissioner to make regulations is admittedly broad . . . [t]his does not mean . . . that there is power in the Commissioner to amend the statute or to require surrender of any part of the statutory privilege as a condition to the grant of permission to file a consolidated return."); *Am. Standard*, 602 F.2d at 261 (invalidating a consolidated return regulation because it exceeded the statutory grant of authority by disallowing Western Hemisphere Trade Corporation deductions otherwise allowed by Congress); *Joseph Weidenhoff, Inc. v.*

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Section 1502 parallels section 482 in several important ways. In section 1502, Congress granted Treasury discretionary authority to regulate how taxpayers could file consolidated tax returns for groups of related corporations, requiring that Treasury ensure consolidated returns were filed "in such a manner as clearly to reflect the income tax liability . . . in order to prevent avoidance of such tax liability." Section 1502. Similarly, in section 482, the Secretary is granted discretionary authority to regulate the reallocation of taxpayer income "if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income." Section 482. In both cases, Congress granted Treasury discretionary authority subject to statutory directives. In neither case is Treasury required to act, and in neither case does the statute require or permit taxpayers to do anything—each is solely a grant of discretionary authority to Treasury. In both cases, Treasury is

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Commissioner, 32 T.C. 1222, 1242 (1959) (the consolidated return statute "does not give [Treasury] authority to prescribe a regulation which will in practical application to a particular taxpayer or group of taxpayers impose a tax on income that would not otherwise be taxed (by limiting the excess profits credit) simply because the taxpayers exercise the privilege of filing consolidated returns, unless it is to prevent tax avoidance.").

permitted to exercise its authority only to the extent necessary to yield a result that clearly reflects income or to prevent tax avoidance.[15]

Rite Aid and the related consolidated return case law preventing the Treasury from overstepping its statutory bounds in the context of promulgating elective regimes applies with equal force here. Thus, even if the parties stipulated that the QCSA rules are an elective safe harbor, Treasury cannot force taxpayers to agree to a condition that violates the fundamental purpose of section 482 in order to gain the benefits of the safe harbor.

Finally, any arguments regarding Treasury's use of *ipse dixit* in promulgating the coordinating amendments should be viewed in light of *Rite Aid* and the one-way nature of section 482. Appellee Br. 54. As discussed above, Treasury may promulgate safe harbors by declaring that the Commissioner will not reallocate taxpayer income if certain conditions are met, like it did with the QCSA safe harbor. What Treasury may not do is impose conditions in a regulatory regime that

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[15] *See* Ronald B. Schrotenboer, *The Arm's-Length Standard and the Limits of IRS Authority*, 17 Transfer Pricing Rep. 430 (BNA), at 2-3, Sept. 25, 2008 (explaining that the origins of both sections 1502 and 482 are rooted in achieving clear reflection of income and the prevention of tax avoidance by shifting income among controlled taxpayers).

are inconsistent with the overriding purpose and bounds of the statute under which such regulations are issued. By requiring taxpayers to report income in a manner contrary to parties transacting at arm's-length, the SBC Requirement does exactly that and is therefore invalid. Any such condition, as Altera correctly notes, must be based on empirical evidence that the condition is consistent with the arm's-length standard, not an *ipse dixit* declaration by Treasury that is inconsistent with the notice and comment process.

CONCLUSION

Treasury did not justify the SBC Requirement on the ground that it was promulgated as a condition to the QCSA safe harbor and the Commissioner has abandoned any such argument by not making it in this appeal. Moreover, even in the context of an elective safe-harbor regime, Treasury cannot impose requirements upon taxpayers that conflict with the authorizing statute. Thus, if the Court were to consider the fact that the QCSA regime is a safe harbor, it still must invalidate the SBC Requirement as an invalid exercise of Treasury's discretion under section 482 because there was no evidence presented to Treasury indicating that parties at arm's-length would share stock-based compensation.

September 26, 2016

Respectfully submitted,

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STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, at the time of filing, undersigned counsel is not aware of any related cases pending in this Court.

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME, TYPEFACE AND TYPE STYLE REQUIREMENTS

This brief complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B) because this brief contains 5,303 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii). The word count was computed by Microsoft Word, the word processing program used to prepare this brief.

This brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type style requirements of Federal Rule of Appellate Procedure 32(a)(6) because this brief has been prepared using Microsoft Word in Century, a proportionally spaced typeface, and 14-point font.

September 26, 2016 Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on September 26, 2016.

I certify that all participants in the case are registered CM/ECF users and that the service will be accomplished by the appellate CM/ECF system, with the exception of the participant listed below, whom we will serve by U.S. mail.

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