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 the United States Tax Court
Nos. 6253-12, 9963-12

BRIEF OF AMICUS CURIAE TECHNET IN SUPPORT OF APPELLEES AND AFFIRMANCE

JOHN I. FORRY
5998 Alcalá Park
Warren Hall Room 136
San Diego, CA 92110-2492
(646) 345-0586
forryjo@gmail.com

Counsel for Amicus Curiae
TechNet

CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1(a), amicus curiae states as follows:

TechNet is a nonprofit organization incorporated in the District of Columbia. TechNet has issued no stock and therefore no publicly held corporation owns ten percent or more of any stock.

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INTEREST OF THE AMICUS CURIAE [1]

Amicus TechNet is a national network of CEOs and senior executives of technology companies, with more than two million employees, in the fields of information technology, e-commerce, biotechnology, clean energy and venture finance. TechNet is organized to promote the growth of the technology industry and to advance America's global leadership in innovation. TechNet submits this brief urging that the Tax Court's faithful application of the Administrative Procedure Act ("APA") be affirmed.[2]

INTRODUCTION

This appeal tests whether Treasury is bound by traditional principles of administrative law. In 2011, the U.S. Supreme Court held, at the urging of the federal government, that Treasury regulations would receive the same degree of deference as regulations put forth by other agencies. *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55-56 (2011). Subsequent decisions

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[1] All parties have consented to the filing of this amicus brief. Pursuant to Federal Rule of Appellate Procedure 29(c)(5), amicus curiae states that (i) no counsel for any party to this proceeding authored this brief in whole or in part, (ii) no party or party's counsel contributed money that was intended to fund preparing or submitting this brief, and (iii) no person other than amicus curiae TechNet or a member of TechNet contributed money that was intended to fund preparing or submitting this brief.

[2] Counsel on this brief (i) is university professor in international finance, investment and taxation at U.S., Asian, European and Latin American law and business schools; and (ii) in preparing this brief represents TechNet and one or more members of TechNet and does not act on behalf of any academic institution or professional firm.

have made clear that Treasury and the IRS are also subject to the same administrative law framework under the APA. *See, e.g.*, *Dominion Resources, Inc. v. U.S.*, 681 F.3d 1313 (Fed. Cir. 2012). The Supreme Court has recently made clear that deference to the agency's interpretation is due only where an agency has satisfied the requisites of the APA. *Encino Motor Cars, LLP v. Navarro*, 136 S. Ct. 2117, 2125 (2016).

Here, Treasury has failed to comply with the reasoned decision-making requirements of the APA by adopting a rule without even the rudiments of evidentiary foundation. In 2003, Treasury issued a regulation that stock-based compensation must be shared in order to satisfy the arm's-length standard. Treas. Reg. § 1.482-7(d)(2). The Tax Court, sitting *en banc*, found that the final rule "lacks a basis in fact." Excerpts of Record ("ER") 64. The Tax Court reasoned that the arm's-length standard "is necessarily an empirical determination" (ER 54), and Treasury "failed to support its belief that unrelated parties would share stock-based compensation . . . with any evidence in the record." (ER 64.) Treasury now comes before this Court, asking for affirmation of the validity of its rule, despite the evidentiary shortcomings of the record.

Not surprisingly, in view of the obvious gap between the record and the rule, the Commissioner and the two sets of Amici supporting him look for rationales unrelated to those on which the rule originally rested. In 2003, Treasury explained

in the preamble to the final rule that "[t]he regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost-sharing arrangements" in comparable circumstances. (ER37-38.) But by 2016, after the intervening loss in the Tax Court, the Commissioner is singing a very different tune. The Commissioner now says that the final rule should be sustained on appeal because it *does not* require any empirical analysis of what parties at arm's length would do. (Opening Br. 34, 38, 46-47, 58, 66.) This is a change in rationale by appellate counsel that is not permitted by longstanding precedent. *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 50 (1983).

The Amici academics supporting the Commissioner take different approaches. One Amici brief takes the road not taken by the Commissioner, and insists that the final rule *is* based on an empirical analysis. Amicus Br. of J. Richard Harvey et al. 25-28 (hereafter "Harvey Amici"). The Harvey Amici claim that arrangements between uncontrolled parties dealing with high value intangibles are not comparable to those between related parties, and hence cannot serve as a model for the treatment of stock based compensation. *See id.* at 17-20. In order to make this assertion, the Harvey Amici rely on materials never presented in the rulemaking. *See id*. Their argument is precluded, both because it is not advanced

by the appealing party (the Treasury) and because it is not based on the rulemaking record before the agency.

The other amici brief argues that the 2003 final rule should be sustained solely on the basis of a 1986 amendment to 26 U.S.C. § 482. *See* Amicus Br. of Anne Alstott et al. 16 (hereafter "Alstott Amici"). The 1986 amendment added language that is commonly referred to as the commensurate with income ("CWI") provision. 26 U.S.C. § 482. Again, this was not the basis for the original Treasury preamble. As the Tax Court explained, the Commissioner could not save the final rule with the CWI language because "Treasury never indicated that it was prepared to independently rely on the [CWI] standard . . . as the basis for adopting the final rule." (ER75; *see also* ER57-60 & n.17.) Furthermore, Treasury has never acknowledged or justified a departure from its longstanding position that CWI is consistent with the arm's-length standard. (ER58-59 & n.19.)

In the end, Treasury's final rule fails under a basic administrative law principle – a rule that is not supported by the rulemaking record cannot stand. Treasury's departure from the rulemaking record in this case is particularly regrettable, because the departure casts doubt on the arm's-length principle of international tax laws on which companies around the world have long relied. The efforts of the Commissioner and the Amici supporting him to overturn the Tax Court's decision and breathe life into the final rule, notwithstanding the lack of any

basis in the rulemaking record or decades of settled international law, should be rejected.

ARGUMENT

I. The Court Should Affirm the Tax Court Opinion Because Treasury Did Not Comply with APA Requirements

A. APA Compliance is Critical to Tax Administration under the Rule of Law

The Court in this case has an opportunity to reaffirm the importance of following appropriate procedures in administering this Nation's tax laws. Ensuring that agencies follow proper administrative procedures is a vital judicial function. Indeed, in the past "[c]ourts have scolded the IRS for twisting laws to further revenue collections rather than Congressional purpose."[3] Likewise, the Court should decline the Treasury's invitation to treat it as a unique agency not subject to ordinary administrative law principles.

The Supreme Court has made clear that tax rulemaking should not be seen as exempt from generally applicable requirements that federal agencies follow. *See Mayo Foundation*, 562 U.S. at 55. The Court declared that it was "not inclined to carve out an approach to administrative review good for tax law only." *Id.* This

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[3] ABA Section of Taxation Report of the Task Force on Judicial Deference, 57 Tax Lawyer 717, 724–25 (Spring 2004) (citation and quotation marks omitted); *see also* Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up to be Tax Lawyers*, 13 Va. Tech. Rev. 517 (1994) (explaining and criticizing the isolation of tax from non-tax jurisprudence, and coining the phrase "tax exceptionalism").

principle was reinforced by the United States Court of Appeals for the D.C. Circuit in *Cohen v. United States*, 650 F.3d 717, 723 (D.C. Cir. 2011) (*en banc*). The court there held that "[t]he IRS is not special in this regard; no exception exists shielding it – unlike the rest of the Federal government – from suit under the APA." *Id.*; *see also* 5 U.S.C. §§ 553, 706(2)(a).[4] It is therefore clear that Treasury's regulations must satisfy both the procedural requirements of the APA and be the product of reasoned decision-making.

Treasury may not end-run the APA requirements by claiming deference under *Chevron*[5] for its interpretation. Recently, the Supreme Court explained that *Chevron* deference to an agency's interpretation "is not warranted where the regulation is 'procedurally defective'—that is, where the agency errs by failing to follow the correct procedures in issuing the regulation." *Encino Motor Cars, LLP v. Navarro*, 136 S. Ct. at 2125. "[W]here a proper challenge is raised to the agency procedures, and those procedures are defective, a court should not accord *Chevron* deference to the agency interpretation." *Id.*

The Tax Court's ruling here is important because it is that Court's first decision applying the APA's reasoned decision-making requirement to a Treasury

[4] Here, the Tax Court found that the final rule is a legislative rule and therefore subject to the notice and comment requirements of the APA. (ER49-51.) The Commissioner does not challenge this finding on appeal.

[5] *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984).

regulation. As one academic explained, "*Altera* represents a natural extension of the Supreme Court's reasoning in the *Mayo Foundation* case, reflecting the spirit of hat decision's rejection of tax exceptionalism from general administrative law requirements, doctrines, and norms."[6] The Tax Court found that the final rule "lacks a basis in fact because Treasury issued the final rule without any evidence that unrelated parties would ever agree to share stock-based compensation . . . ." (ER57.)

The Commissioner does not challenge the Tax Court's ruling in this respect and instead tries to circumvent it, now arguing that its rulemaking was "not a fact-finding endeavor." Opening Br. 43. The Commissioner's attempt to inject this notion into the current appeal, however, comes thirteen years too late. Even assuming the Court could consider these new arguments, the agency itself never acknowledged or sought to justified this policy reversal in the course of its rulemaking.

B. The Tax Court Correctly Held that the Final Rule Failed APA Requirements

The Supreme Court and this Court have long recognized that an agency violates the APA's ban on arbitrary and capricious action when it departs from a

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[6] Kristin Hickman, *The Tax Court Delivers An APA-Based Smackdown* (July 28, 2105), *available at* http://taxprof.typepad.com/taxprof_blog/2015/07/hickman-altera-corp-subs-v-commissioner-the-tax-court-delivers-an-apa-based-smackdown.html (last visited Sept. 22, 2016).

prior decision or practice without an adequate explanation. "An agency's view of what is in the public interest may change, either with or without a change in circumstances. But an agency changing its course must supply a reasoned analysis." *Motor Vehicle Manuf's Ass'n v. State Farm Mutual Auto Ins. Co*., 463 U.S. 29, 57 (1983). "[D]epartures from prior policy must be recognized and explained." *Modesto Irrigation Dist. v. Gutierrez*, 619 F.3d 1024, 1034 (9th Cir. 2010); *W. States Petroleum Ass'n v. EPA*, 87 F.3d 280, 284 (9th Cir.1996) (stating that an agency "must clearly set forth the ground for its departure from prior norms"). The agency must at least "display awareness that it is changing position" and "show that there are good reasons for the new policy." *FCC v. Fox Television Stations, Inc*., 556 U.S. 502, 515 (2009). "It follows that an unexplained inconsistency in agency policy is a reason for holding an interpretation to be an arbitrary and capricious change from agency practice." *Encino Motor Cars, LLP v. Navarro*, 136 S. Ct. at 2126 (quotations, brackets, and citation omitted).

An agency has a heightened obligation to justify an about-face when, as here, its prior policies have induced detrimental reliance. *Fox Television*, 556 U.S. at 515-16; *Associated Builders & Contractors v. Shiu*, 773 F.3d 257, 263 (D.C. Cir. 2014) (*Fox* requires "heightened review"). As the Tax Court found, "the arm's-length standard is incorporated into numerous tax treaties" at the urging of the United States and sets the international transfer pricing norm. (ER67-68.) "In

such cases . . . a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy." *Fox Television*, 556 U.S. at 515-16.

Throughout the rulemaking, Treasury time and again expressed its adherence to the arm's-length standard. Treasury displayed no awareness that it was departing from the prior, longstanding meaning of that term. In the notice of proposed rulemaking, Treasury made clear that "Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard *consistent with* the arm's length standard." 67 Fed. Reg. 48997, 48998 (emphasis added). In the preamble to the final rule, Treasury confirmed that it was adhering to the arm's-length standard. (ER57.) Treasury stated repeatedly that its final rule was "consistent with the arm's length standard." 68 Fed. Reg. 51171, 51172-74, 51176. It also explained that the final rules "have as their focus reaching results consistent with what parties at arm's length generally would do" in similar circumstances. (ER37-38.) Treasury considered the empirical evidence of unrelated party transactions in the record and rejected it – not because evidence of uncontrolled party transactions was irrelevant – but because Treasury ostensibly believed the transactions were not sufficiently comparable to serve as objective

evidence. (ER38.)[7] These actions confirm that Treasury was following settled law that the arm's-length standard is an empirical question that is informed by evidence of comparable transactions between unrelated parties.

Only now, thirteen years later, does Treasury assert that in 2003, it was abandoning the long-established law of empirically evaluating unrelated party transactions by reference to arm's-length dealings. Treasury now purports to apply a non-empirical standard on appeal, when it failed to give notice or even acknowledge this change in position in rulemaking. "If the APA's notice requirements mean anything, they require that a reasonable commenter must be able to trust an agency's representations about *which particular* aspects of its proposal are open for consideration." *Envtl. Integrity Project v. E.P.A.*, 425 F.3d 992, 998 (D.C. Cir. 2005) (emphasis in original); *id.* at 996 (noting that courts have "refused to allow agencies to use the rulemaking process to pull a surprise switcheroo on regulated entities").

Since Treasury did not acknowledge that it was changing positions – a threshold requirement – it necessarily did not justify the policy reversal. Treasury did not acknowledge a change in position. Treasury did not offer any good reasons for jettisoning the prior precedent and adopting a non-empirical standard. It did

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[7] *See* 68 Fed. Reg. 51173 (stating that "[t]he uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles").

not try to harmonize its current position with the decades of prior precedent. In fact, Treasury did not even acknowledge the overwhelming precedent to the contrary. An agency's "failure to come to grips with conflicting precedent constitutes 'an inexcusable departure from the essential requirement of reasoned decision-making.'" *Ramaprakash v. FAA*, 346 F.3d 1121, 1125 (D.C. Cir. 2003) (Opinion of then-Circuit Judge John Roberts, *citing CBS v. FCC,* 454 F.2d 1018, 1027 (D.C. Cir. 1971) and the APA, 5 U.S.C. § 706(2)(A)). Treasury's "[s]ilence in the face of inconvenient precedent is not acceptable." *Jicarilla Apache Nation v. United States Dep't of Interior*, 613 F.3d 1112, 1120 (D.C. Cir. 2010).

Without a cogent explanation for its change in course, Treasury's regulation is inherently arbitrary and capricious. *Nw. Envtl. Def. Ctr. v. Bonneville Power Admin*., 477 F.3d 668, 687-91 (9th Cir. 2007) (without reasoned explanation, agency departure from a two-decade-old precedent is arbitrary and capricious); *Nat'l Treasury Emps. Union v. Fed. Labor Relations Auth*., 404 F.3d 454, 457 (D.C. Cir. 2005) (agency's "unexplained departure from prior agency determinations is inherently arbitrary and capricious"); *Comcast Corp. v. FCC*, 526 F.3d 763, 769 (D.C. Cir. 2008) ("[A]n agency's unexplained departure from precedent must be overturned as arbitrary and capricious."). "An arbitrary and capricious regulation of this sort is itself unlawful and receives no *Chevron* deference." *Encino Motor Cars, LLP v. Navarro*, 136 S. Ct. at 2126.

II. The Harvey Amici's Argument Cannot Save the Final Rule

A. The Harvey Amici's "Alternative Argument" Improperly Attempts to Build a New Administrative Record

The Harvey Amici offer a purported empirical basis to support the final rule. *See* Harvey Amici Br. 4–22. They acknowledge that their approach is different from what Treasury argues in its opening brief. *See id.* at 2-3. In fact, the Harvey Amici have the exactly the opposite premise. In its opening brief, the Commissioner asserts that Treasury made no empirical judgments and therefore the final rule does not need to be tested against the factual record of the rulemaking. *See, e.g.*, Opening Br. 34, 38, 58. The Harvey Amici brief, in its "alternative argument," seeks to rely on "what unrelated parties would have done in comparable circumstances, and to which evidence from uncontrolled transactions, properly adjusted, could be relevant." Harvey Amici Br. 2. The Harvey Amici brief attempts to explain the empirical evidence with its own empirical theory of the facts. All of their purported facts, such as behaviors and attitudes of the parties at arm's length, are outside the record. *See, e.g.*, Harvey Amici Br. 10-12.

These arguments should not be considered. A court cannot, of course, credit an *ex post* justification that was never relied on by the agency. *See Sec. & Exch. Comm'n v. Chenery Corp.*, 332 U.S. 194 (1947). Moreover, amici cannot present an argument that has been waived by the appealing party. *See, e.g., Zango Inc. v.*

Kaspersky, 568 F.3d 1169, 1177 & n.8 (9th Cir. 2008) ("An amicus curiae generally cannot raise new arguments on appeal, . . . and arguments not raised by a party in an opening brief are waived.") (citations omitted).

B. The Harvey Amici Jettison the Arm's-Length Standard, in Direct Contravention of the Final Rule

The arguments of the Harvey Amici fail on their substance as well. They argue that comparing controlled cost-sharing transactions with uncontrolled transactions is futile because the two situations are not comparable. Harvey Amici Br. at 7–8. The Commissioner did not raise this argument on appeal, and for good reason. If this argument is accepted, the arm's-length standard becomes entirely inoperable. After all, there will always be differences between the position of controlled and uncontrolled taxpayers. The whole "purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer." *CIR v. First Security Bank of Utah*, 405 U.S. 394, 400 (1971); *see also* Treas. Reg. § 1.482-1(a)(1). Congress was well aware that controlled and uncontrolled taxpayers stand on different footings, but this has not prevented the arm's-length standard from being applied consistently for almost eight decades in the United States and abroad, or from being incorporated in numerous international treaties.[8]

[8] *See A Study of Intercompany Pricing under Section 482 of the Code*, IRS Notice 88-123, 1988-2 C.B. 458, 1988 WL 561206 at *32 (1988) (hereinafter, "White Paper") ("The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is

This Court cannot disregard Congress's purpose in enacting Section 482 and the implementing regulations thereunder.

III. The Alstott Amici Cannot Invoke the CWI Standard to Circumvent the Arm's-Length Standard

A. The Final Rule Relied on the Arm's-Length Standard

The Alstott Amici ask this Court to sustain the Treasury regulation, despite its fatal procedural flaws, solely on the basis of the commensurate with income ("CWI") provision of 26 U.S.C. § 482. Alstott Amici Br. at 4. But the CWI standard provides no basis for disregarding the arm's-length standard. The Tax Court explained that "Congress never intended the commensurate-with-income standard to supplant the arm's-length standard." (ER56-57.) *See also Xilinx Inc. & Subsidiaries v. C.I.R.*, 125 T.C. 37, 57 (2005) (explaining that "the commensurate with income standard was intended to supplement and support, not supplant, the arm's-length standard."). The IRS's own White Paper states that the CWI standard was designed to approximate what uncontrolled companies did at arm's length:

> To allay fears that Congress intended the commensurate with income standard to be implemented in a manner inconsistent with international transfer pricing norms and U.S. treaty obligations, Treasury officials publicly stated that Congress intended no departure from the arm's

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incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues.").

> length standard, and that the Treasury Department would so interpret the new law. Treasury and the Service continue to adhere to that view, and believe that what is proposed in this study is consistent with that view.[9]

Treasury affirmed in the rulemaking that CWI is consistent with the arm's length standard. *See* 67 Fed. Reg. at 48,998. It did not rely solely on the CWI standard when it published its notice of proposed rulemaking, and it affirmed that it was actually applying the arm's-length standard in the preamble to its final rule. *See* 68 Fed. Reg. at 51172. As the Tax Court correctly found, Treasury never indicated that it was prepared to rely independently on the CWI standard as the sole basis for adopting the final rule. (ER 59.)

B. The Alstott Amici Provide No Basis to Leave the Final Rule in Place on Remand

The Alstott Amici urge the Court to remand and leave the regulation in place so that Treasury can clarify its explanation. *See* Alstott Amici Br. 29-30. However, the only reasonable remedy for Treasury's arbitrary rulemaking is *vacatur*. "[V]acatur of an unlawful agency rule normally accompanies a remand." *Alsea Valley All. v. Dep't of Commerce*, 358 F.3d 1181, 1185 (9th Cir. 2004). At the outset, the Commissioner has not requested a remand without *vacatur*, and therefore has waived any argument for such a limited remedy. *See Zango Inc.*, 568 F.3d at 1177 & n.8.

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[9] *White Paper*, 1988 WL 561206 at *31.

Moreover, a remand without *vacatur* makes no sense in the context of a deficiency case. This is not a pre-enforcement challenge to the regulations but involves a dispute over Altera's tax liabilities for its 2005-2007 tax years. As one academic explained, "When the Tax Court declared the international tax regulations invalid, it did not actually vacate them. Rather, it disregarded them in deciding the matter in front of it (Altera's tax liability)."[10] Thus, "the Ninth Circuit should disregard the invitation to remand without vacating."[11]

The Alstott Amici cite two cases in support of their argument, but both cases concerned pre-enforcement challenges to rulemakings under environmental statutes. In both cases, the Court emphasized the irreversible environmental consequences that could follow if the EPA designations were immediately vacated. In *Idaho Farm Bureau Federation v. Babbitt*, 58 F.3d 1392 (9th Cir. 1995), for example, the Court left in place the EPA's endangered species designations based on concerns that immediately vacating the regulation threatened the potential extinction of an animal species. *See id.* at 1405 ("In the present case, concern exists regarding the potential extinction of an animal species."); *see also Western Oil & Gas Association v. U.S. E.P.A.*, 633 F.2d 803, 813 (9th Cir. 1980) ("reluctant[ly]" leaving in effect the challenged designation—that designated

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[10] Andy Grewal, *Altera v. Commissioner* (Aug. 10, 2016), *available at* http://yalejreg.com/nc/1679-2/ (last visited Sept. 22, 2016).

[11] *Id.*

certain geographical areas in California as failing to meet federal air quality standards—during reenactment of the deliberative process "to avoid thwarting in an unnecessary way the operation of the Clean Air Act in the State of California during the time the deliberative process is reenacted"). Thus, in both of these decisions, the "Ninth Circuit expressed special concern for the potentially one-sided and irreversible consequences of environmental damage prompted by vacating defective rules during remand." *Natural Resources Defense Council, Inc. v. United States Depart. of Interior*, 275 F. Supp. 2d 1136, 1143-44 (C.D. Cal. 2002). Here, by contrast, no regulatory vacuum exists if § 1.482(d)(7) is invalidated. The agency and industry would continue to follow the empirical arm's-length standard, which has governed for decades in the United States and abroad. As such, the general rules of administrative procedure as described above – and not rare exceptions – should apply.

CONCLUSION

The Court should affirm the opinion of the Tax Court in its entirety.

DATED 22nd of September, 2016.

/s/ John I. Forry
John I. Forry
5998 Alcalá Park
Warren Hall Room 136
San Diego, CA 92110-2492
(646) 345-0586
forryjo@gmail.com

Counsel for Amicus Curiae TechNet

CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 29(d) and 32(a)(7)(B)(i) because it contains 3,995 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5)(A) and the type style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Office Word 2010 in 14-point Times New Roman.

DATED September 22, 2016.

s/ John I. Forry
John I. Forry

CERTIFICATE OF SERVICE

I certify that on September 22, 2016, 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. I further certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

s/ John I. Forry
John I. Forry