# TRANSFER PRICING LITIGATION FROM A TO Z

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A number of transfer pricing cases, many with potentially significant precedent value and tax provision consequences, are either at trial or proceeding to trial. We selected two interesting cases, *Altera* and *Zimmer*, to brief and also offer our transfer pricing commentary.

## ALTERA CORP.

Altera Corp.[1] is a California-based manufacturer of programmable semiconductors and related products. It has sales of $1.8 billion world-wide. The taxpayer petitioned the U.S. Tax Court, challenging adjustments in the amount of $96.6 million, most of which relates to the inclusion by the I.R.S. of costs associated with employee stock options in its cost-sharing agreement ("C.S.A.") with its Cayman Island affiliates for years 2004 through 2007.

The taxpayer's challenge to the adjustments considers the validity of the 2003 cost-sharing regulations,[2] The Violation of Administrative Procedures Act, and the legal standard of review.

Altera claims that the 2003 Cost Sharing Regulations, which are amendments to the 1995 Regulations, violate the arm's length standard by requiring the related parties to share stock-based compensation, a transaction that is not undertaken by unrelated parties. Therefore, Treas. Reg. §1.482-7(d)(2), which requires the inclusion of stock options in the cost pool, is invalid as a matter of law because it is inconsistent with the arm's length standard set forth in Treas. Reg. §1.482-1(b)(1). In fact, the intention of I.R.C. §482 is to achieve tax parity, which can only occur if the activities of unrelated parties are considered.

The I.R.S. claims that the sharing of options costs is governed by the commensurate-with-income-standard, which does not require that third-party activities be considered, but only that it "achieves an arm's length result." Accordingly, the behavior of unrelated parties isn't relevant to determining whether its cost-sharing transaction terms are consistent with the arm's length standard, and it can be determined in any way as long as the desired result is achieved. The I.R.S. position is that stock-based compensation is an economic cost that must be included in the pool, otherwise it would distort income.

Judge Marvel asked the I.R.S. how they could analyze an issue to determine if it achieved an arm's length result if it did not take into consideration what uncontrolled parties were doing in the same situation. In response, the I.R.S. said that tax parity

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[1] *Altera Corp. v. Com'r., T.C.*, Nos. 6253-12, 9963-12, argument on cross motions for partial summary judgment, 7/24/14.

[2] I.R.C. §482, Treas. Reg. §1.482-7(d)(2).

is achieved "if you reflect true taxable income." Therefore, taxpayers that follow the qualified cost-sharing regime achieve parity. Marvel replied, "It sounds to me like you are saying the only relevant standard is the commensurate-with-income and not the arm's length standard."

Marvel further noted that while the preamble to the 2003 Regulations states that evidence submitted by stakeholders was not sufficient, the agency did not explain why it came to that conclusion. Furthermore, the record does not support the I.R.S.'s position. "Shouldn't there be something in the rulemaking record that supports your belief that the failure to share stock-based compensation leads to distortion?" Marvel asked.

***"The intention of I.R.C. §482 is to achieve tax parity, which can only occur if the activities of unrelated parties are considered. underlying statute implement."***

Under the Administrative Procedures Act ("A.P.A."), a final rule cannot be enforced unless it is the product of "reasoned decision making" and is "consistent with the underlying statute it is designed to implement." Altera pointed out that the I.R.S. in fact adopted the stock-based compensation provision over the objections of multiple stakeholders, who testified that no unrelated party ever shares such costs in development deals.

Altera says that the Regulations require the I.R.S. to rely on the arm's length standard, but the administrative record does not show that the sharing of equity-based compensation ever occurs among unrelated parties. The I.R.S. is obligated under the A.P.A. to consider that record. If not, it is not the product of reasoned decision-making and the regulation should not pass review.

With regard to the final issue of the legal standard of review, the I.R.S. claims that the 2003 Regulations meet the two-step test set out by *Chevron*[3] and is further supported by *Mayo*,[4] which held that agency rules deserve deference from reviewing courts because the formulation of the policy requires "more than ordinary knowledge respecting the matters subjected to agency regulations," so as long as it is reasonable.

Altera claims that the standard should satisfy *Chevron* and *Motor Vehicle Manufacturer's Ass'n*,[5] in which the Supreme Court held that in amending a regulation, an agency must examine "relevant data" and "articulate a satisfactory explanation." If an agency fails to do so, the change is arbitrary and capricious and cannot be upheld. Altera therefore claims that the change from the 1995 Regulations to the 2003 Regulations cannot be upheld.

The Altera case is one of a number of cost-sharing cases in process. It is unique however in that it is, for all intents and purposes, a retrial of the issue of stock option expense inclusion in a C.S.A. as decided in *Xilinx*.[6] Considerable evidence of the behavior of independent signatories to joint technology development agreements was offered in amicus briefs and motions during the *Xilinx* trial proceedings. The

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[3] *Chevron USA Inc. v. Natural Resources Defence Council*, 467 U.S. 837 (1984).

[4] *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704, 2011 BL 6645 (2011).

[5] *Motor Vehicle Manuraterers Ass'n. of the U.S. Inc. v. State Farm Mutual Auto Insur. Cos.*, 463 U.S. 29 (1983).

[6] 125 T.C. 37 (2005), *rev'd*, 567 F.3d 482 (9th Cir. 2009), *opinion withdrawn*, 592 F.3d 1017 (9th Cir. 2010), *and aff'd*, 598 F.3d 1191 (9th Cir. 2010)

evidence submitted by trade groups and experienced industry participants supported the notion that arm's length parties do not share stock option costs.

The I.R.S. position will require clarification of the meaning of the arm's length standard. Does the standard apply to make parties transact as arm's length parties would, or cause transacting parties (or one transacting party, usually known as the tested party) to report an arm's length outcome (in this case income)?

Given that an apparent shortcoming in the I.R.S. position is its failure to adequately consider the actions of uncontrolled parties in the same situation, we considered the general definition of costs in one of the most R&D intensive industries – defense.

Defense contractors are required to account for their costs in conformity with the Federal Acquisition Regulation ("F.A.R.") Cost Principles. One of the elements of cost that is allowable under a cost plus R&D contract is stock option expense incurred as a result of the options issuance to employees carrying on the specified R&D activity. Stock appreciation rights are treated like options for F.A.R. cost purposes under these rules. Stock options only have a positive cost attribute if the option is in the money on the issue date (*i.e.*, the first date on which the number of units and the option price are known), implying that stock option cost is not always positive (if in fact the F.A.R. Cost Principles are appropriate guidance under I.R.C. §482.

Determining whether the F.A.R. principles are relevant to the pricing of joint development, joint venture of cost-sharing agreements require an analysis of comparability of attributes of the agreements carried out under Reg. §1.482-1(d). It is this comparability standard that the I.R.S. contends is of relative unimportance when contrasted with the commensurate-with-income standard in the case of Altera. Whether either an accepted standard or evidence of the behavior of third parties, such as the F.A.R. Cost Principles, is persuasive evidence in the view of the courts remains to be seen. As always, transfer pricing matters are won and lost on some combination of legal analysis and empirical evidence.

## ZIMMER HOLDINGS INC.

Zimmer Holdings Inc.[7] is a publicly traded company based in Warsaw, Indiana, with worldwide operations and annual sales of $4.4 billion. Its Dutch subsidiary, Zimmer Manufacturing B.V., produces medical products through its Puerto Rico operations.

Zimmer is challenging income adjustments made by the I.R.S. of $228.5 million related to the licensing of its intangibles to its Dutch subsidiary, claiming that the adjustments made by the I.R.S. are incorrect and no tax is due for the years 2005 through 2007.

The I.R.S. has taken three separate positions. The first addresses the transfer pricing adjustments under I.R.C. §482. Zimmer claims the adjustment is incorrect because the intercompany pricing is arm's length. The intercompany agreements provide that Zimmer Manufacturing B.V. assumes all risks associated with the production of medical products and indemnifies the parent company for all liabilities, losses, claims, and costs.

[7] *Zimmer Holdings Inc. v. Comm'r,* T.C., No. 19703-14, filed 8/13/12.

Though at opposite ends of the docket's alphabet, *Zimmer* shares at least one important trait with *Altera* from a transfer pricing perspective. The evaluation of comparability under I.R.C. §482 may well become part of the arguments of both parties and be instructive to the decision.

Where we considered the availability of third-party conventions on stock option expense treatment in the circumstance of *Altera*, the terms in agreements between independent licensors and licensees may become relevant in the case of *Zimmer*. While a review of the contractual terms pertaining to risk in the Zimmer Manufacturing B.V. agreement against other licensing agreements may lead to the conclusion that the Zimmer dealings occurred at arm's length, the actual risks incurred by the parties and the economic circumstances of the parties in the context of the intercompany licensing transaction may in fact have departed from the intent expressed in the agreement. In this case, substance determines the treatment of the transaction for transfer pricing purposes. Also relevant may be evidence from arm's length contracts and other evidence of the outcomes of commercial arrangements, which may or may not accord with the actual conduct of the parties.

Intercompany agreements are essential to have in place in the case of intangible assets transactions. Agreements evidence the intent of the parties, and are often the first line of defense in a comparability dispute. We expect *Zimmer* may, in some part, be decided on the basis of comparing intent as expressed in the intercompany agreement with actions as properly evidenced. Cooperation and communications between tax function leaders in companies and their operations and legal colleagues go a long way, in our view, to making sure form matches substance.

The second position regarded alternative adjustments under I.R.C. §367(d). Zimmer claims that that §367(d) does not apply as there were no transfers specified intangibles under I.R.C. §936(h)(3)(B), specifically goodwill and workforce-in-place. Zimmer also claims in passing its regulations under I.R.C. §367(d), the I.R.S. violated the Administrative Procedures Act. Additionally, it maintains that the §367 allegations are "internally inconsistent" because they apply royalty rates to an erroneous revenue base.

As a third alternative argument, the I.R.S. argued that intellectual property was transferred under §367(a) and imputes a transfer of $1 billion in underlying intangibles from the U.S. parent to the Dutch subsidiary. The intellectual property license agreements worth $880 million, workforce-in-place valued at $2.5 million, and goodwill valued at $11.6 million, has zero basis and therefore the transfer results in a taxable gain of $998.6 million.

Zimmer argues that no license agreements were transferred to Zimmer manufacturing, so the adjustment based on valuation of property isn't subject to §367(a)(1). Further, neither goodwill nor workforce-in-place is subject to §367(a)(1).