TAX COURT STRIKES DOWN I.R.S. POSITION ON STOCK-BASED COMPENSATION IN *ALTERA* CASE

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INTRODUCTION

In its *Altera* decision[1] issued on July 27, 2015, the U.S. Tax Court struck down 2003 cost-sharing regulations that require the sharing of stock-based compensation ("S.B.C.") under a cost sharing agreement ("C.S.A.") with a party under common control for purposes of Code §482. The court held that the regulations, Treas. Reg. §1.482-7(d)(2), lack "a basis in fact" and are invalid as a matter of law. This issue was the focus of an earlier Tax Court decision, *Xilinx Inc. v. Comm'r* ("*Xilinx*"),[2] involving a year when the regulations did not provide for a specific rule with respect to S.B.C.

In *Xilinx*, the court addressed the application of the 1995 cost-sharing regulations that allowed controlled entities to enter into a qualified cost-sharing agreement ("Q.C.S.A.").[3] The court held that a Q.C.S.A. need not share S.B.C. costs – meaning expenses related to employee stock options – because parties operating at arm's length would not do so. The court underscored that the arm's-length standard was of paramount importance in determining costs to be covered under a Q.C.S.A.

The I.R.S. has not yet decided whether to appeal the holding in *Altera*, according to a statement by the Acting Director of the I.R.S. Office of Transfer Pricing Operations, David Varley.[4] If the case is appealed, the matter will be heard by the Ninth Circuit Court of Appeals, the same court that decided Xilinx.

The *Altera* decision touches two areas that have been in issue for decades:

- **<u>In the C.S.A. context, does the commensurate-with-income standard prevail over the arm's-length standard?</u>**

  In other words, will the arm's-length standard control over a specific regulatory provision that may require taxpayers to do something that, arguably, parties at arm's length would not do? Or should in a such a scenario the commensurate-with-income standard apply, and if so, would it subject the transaction to a different set of criteria than the arm's-length standard?

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1. *Altera Corp. v. Comm'r.*, 145 T.C. __, No. 3 (July 27, 2015) ("*Altera*").
2. *Xilinx Inc. v. Comm'r.*, 125 T.C. 37 (2005), ("*Xilinx 1*"), rev'd. 567 F.3d 482 (9th Cir. 2009) ("*Xilinx 2*"), reversal withdrawn 592 F.3d 1017 (9th Cir. 2010), and aff'd. 598 F.3d 1191 (9th Cir. 2010) ("*Xilinx 3*").
3. In the following references to "C.S.A." assume that such agreements meet the Q.C.S.A. standards; the terms are thus used interchangeably.
4. See *International Taxes Weekly Newsletter*, Vol. 6, No. 31 (Aug. 4, 2015).

- **<u>Is the standard of review of regulations process based or rule oriented?</u>**

  The first is based on the *State Farm*[5] decision, the second relates to a two-prong test based on the *Chevron*[6] decision.

This article evaluates the impact of the *Altera* decision in light of administrative law principles applicable to the I.R.S. and economic principles applicable to controlled intercompany transactions and the requirement under U.S. tax law to conduct transactions under arm's length terms and conditions.

COST-SHARING REGULATIONS

Under the regulations, a "cost sharing arrangement" is an arrangement in which controlled participants share the costs and risks of developing identified intangibles in proportion to the reasonably anticipated benefits for each participant.[7] In broad terms, a C.S.A. must meet certain requirements for it to be a Q.C.S.A.

"A 'cost sharing arrangement' is an arrangement in which controlled participants share the costs and risks of developing identified intangibles in proportion to the reasonably anticipated benefits for each participant."

- All controlled participants must commit to, and in fact, engage in cost sharing transactions including the cost of platform transactions.
- The C.S.A. must be recorded in writing in a contract that is contemporaneous with the formation (and any revision) of the C.S.A. and must cover items such as (i) a complete list of participants, (ii) the costs to be shared, (iii) the anticipated benefits of each participant, (iv) the methodology for sharing costs and anticipating benefits, (iv) the functions and risks that each controlled participant will undertake, (v) the form of payment for platform contributions, and (vi) the duration of the agreement.

All intangible development costs must be shared if and to the extent such costs relate to intangible development activity.[8] Intangible development costs include all costs, in cash or in kind (including S.B.C.), incurred in the ordinary course of business and that are directly identified with, or are reasonably allocable to, the intangible development activity.[9] The term "stock-based compensation" means any compensation provided by a controlled participant in a C.S.A. to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including transfers of property that are taxable under Code §83 and stock options covered by Code §421.[10] The regulations go on to provide that the cost attributable to S.B.C. is equal to the amount allowable as a deduction for Federal income tax purposes.[11]

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5 *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) ("*State Farm*").

6 *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) ("*Chevron*").

7 Treas. Reg. §1.482-7(b).

8 Treas. Reg. §1.482-7(d)(1).

9 Treas. Reg. §1.482-7(d)(1)(iii).

10 Treas. Reg. §1.482-7(d)(3)(i).

11 Treas. Reg. §1.482-7(d)(3)(iii).

THE *ALTERA* DECISION

In *Altera*, the U.S. parent entered into a Q.C.S.A. with its Cayman Islands subsidiary, Altera International. The purpose of the C.S.A. was to pool resources in order to conduct research and development ("R&D") activities using certain pre-cost-sharing intangible property ("I.P.") for a defined period. Under the C.S.A., the U.S. parent included the cash compensation of its R&D employees, but not S.B.C., in the pool of costs to be shared. As such, the payments made by Altera International to the U.S. parent did not include the reimbursement of any portion of the U.S. parent's S.B.C. costs. The I.R.S. proposed the following adjustments to the cost sharing payments received by the U.S. parent corporation.

Year	Cost-Sharing Payment Adjustment
2004	$24,549,315
2005	$23,015,453
2006	$17,365,388
2007	$15,463,565

Notices of tax deficiency were issued based on the final 2003 C.S.A. regulations. Bringing the taxpayer into compliance with the final regulations was the sole purpose of the cost sharing adjustments contained in the notice of deficiency.

The taxpayer raised two arguments in its brief. First, it argued that the C.S.A. regulations are a legislative rule under §553(b) of the Administrative Procedures Act ("A.P.A.") and are subject to notice and comment requirements because, if valid, the regulations would have the force of law. Alternatively, the taxpayer contended that if the final rule were an interpretive rule, it would not have the force and effect of law and would not be binding on the court. The I.R.S. contended that the C.S.A. regulations have the force of law, but disagreed that it was a legislative rule, and took the position that it complied with the A.P.A. notice and comment requirements mentioned above.

In an opinion that was reviewed by the full Tax Court on cross-motions for summary judgment, the court agreed with taxpayer, Altera Corp., that the final C.S.A. regulations violated the arm's-length standard because there is no evidence unrelated parties ever share such costs. The Tax Court faulted the Treasury Department for ignoring the extensive testimony that unrelated parties do not share S.B.C. costs, and noted that, in adopting the final rules, the Treasury never responded to those comments and never explained its basis for concluding otherwise. Moreover, the Tax Court concluded that the final C.S.A. regulations were legislative rules promulgated by an administrative agency, and were the I.R.S. adjustment to be sustained, the taxpayer would have been confronted with adjustments to its U.S. taxable income amounting to $80.4 million over a period of four years.

To reach its decision, the Tax Court looked at the following factors:

- Principles of administrative law regarding the procedure for an administrative agency to follow when adopting a legislative rule;
- The submissions to the I.R.S. when the final C.S.A. regulations were issued in which the premise of the regulations was challenged on the basis that unrelated parties acting at arm's length do not conduct themselves in the manner mandated by the final C.S.A. regulations in respect of S.B.C. payments;
- The absence of any analysis by the I.R.S. that took into account the foregoing submissions, which reflect a position that when independent parties deal with each other in uncontrolled transactions to develop I.P. the circumstances are not comparable to a transaction between related parties and should therefore be ignored;
- The standard to be followed by a court when considering a challenge to the validity of an administrative rule; and
- The final holding in *Xilinx*, which was not followed by the I.R.S. in the final C.S.A. regulations.

If and when the Tax Court decision in *Altera* becomes final and is not reversed legislatively, it may have a profound effect on the way the U.S. applies rules under B.E.P.S. that pertain to hard-to-value intangibles. The analysis by the Tax Court, based on U.S. rules and standards, appears to be diametrically opposed to the *ipsa dixit* pronunciations of Action 8.

ARM'S-LENGTH STANDARD V. COMMENSURATE-WITH-INCOME STANDARD

Transfer Pricing Rules – Legal Background

Related-party transactions are subject to a special statutory rule to ensure that each related party reports the proper income or expense arising from a specific transaction. Code §482 provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (*within the meaning of section 936 (h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible*). [Emphasis added.]

The first direct predecessor of the current Code §482 dates back to the Act of 1921. The commensurate-with-income rule (also called the "Super Royalty Provision") was added by Congress decades later, in 1986. With the proliferation of international transactions in the early 1960's, Code §482 gained importance. The House of Representatives proposed the adoption of a measure to add a new subsection to Code §482, which would require taxpayers to demonstrate the use of an arm's-length standard in the pricing of intercompany transactions or else an apportionment formula based on relative economic activities would be used.[12] The House proposal was not adopted. Instead, the Conference Committee stated that Code §482 already granted enough power to the I.R.S. to allocate income and deductions to taxpayers. Nevertheless, it prompted the Treasury to develop regulations that would "provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income."[13] The Treasury followed this recommendation and issued regulations in 1968 (the "1968 Regulations"), which, in their main parts, remain in effect. The 1968 Regulations reaffirm the arm's-length standard as a fundamental principle in transfer pricing transactions.

"The arm's-length standard constitutes the baseline against which all transfer pricing between related parties is tested and judged."

Under the regulations, the failure to clearly reflect income or the presence of an arrangement for the avoidance of taxes subjects such transactions to allocations of income or expense under Code §482 and Treas. Reg. §1.482-1(a)(1). In those cases, the I.R.S. will aim at determining the "true taxable income" of the taxpayer. In the effort to determine the taxpayer's true taxable income, the regulations introduce the arm's-length standard.

The arm's-length standard constitutes the baseline against which all transfer pricing between related parties is tested and judged. The arm's-length standard requires intercompany transactions to generate results consistent with those transactions unrelated parties would have engaged in (*i.e.*, arriving at prices conforming to the market price).[14] On these premises, arm's-length behavior is determined on a case-by-case basis, turning on the facts and circumstances of each transaction. Conceptually, it assumes that "comparable" transactions between unrelated persons in "comparable" markets and circumstances actually exist.

With respect to intangible development costs, special rules under the regulations were issued in 1995. Before then, the first U.S. transfer pricing regulations, promulgated in 1968, did not provide for rules regarding C.S.A.'s. At the time the transfer pricing regulations were written, cost sharing rules were proposed but never finalized. The proposed rules were ultimately withdrawn, apparently because there was substantial disagreement regarding the proper method of handling such transactions. It was not until 1995, when Congress introduced the "commensurate-with-income" requirement to Code §482, that the cost sharing discussion was revived. Initially, this rule was construed to evidence "a rejection of the arm's-length standard in that unrelated parties typically do not deal with each other in such a matter."[15] In its *Study on Intercompany Pricing*, also known as the White Paper of 1988, the Treasury acknowledged the fact that comparables are generally unavailable in the

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12 Martinez, Bibiana A. Cruz, "The Arm's Length Standard vs the Commensurate with Income Standard: Transfer Pricing Issues in the Valuation of Intangible Assets," 305.

13 "Treasury Department & Internal Revenue Service, A Study of Intercompany Pricing," *supra* note 5, at 10 ("White Paper").

14 Treas. Reg. §1.482-1(b)(1); Treas. Reg. §1.482-1(i)(9); and Treas. Reg. §1.482-1(i)(10) (describing the intercompany transaction as the "controlled" transaction and the latter transaction as an "uncontrolled" transaction).

15 Levey, Marc M. and Stanley C. Ruchelman, "Section 482-The Super Royalty Provisions Adopt the Commensurate Standard," *The Tax Lawyer*, 41, no. 3 (1988): 611, 636.

case of intangible assets and that "regulations fail[ed] to resolve the most significant and potentially abusive fact patterns."[16] The commensurate-with-income standard was considered to create a solution to the abuses it identified for cases when comparables did not exist.[17] According to the Treasury, the periodic adjustments these methods provided for were consistent with the arm's-length standard since "unrelated parties generally provide some mechanism to adjust for change in the profitability of transferred intangibles."[18] In its proposed regulations 1992 and final regulations 1994, the Treasury moved away from B.A.L.R.M. and re-emphasized the arm's-length standard.[19] What some observed in this respect as relaxation of the commensurate-with-income standard was construed by others as its loss of relevance.

C.S.A. and S.B.C. Issue

Despite on and off discussions of the need for C.S.A. rules, specific rules were not adopted until 1995, when the I.R.S. issued Treas. Reg. §1.482-7, effective for taxable years beginning on or after January 1, 1996 (the "1995 Regulations"). The 1995 Regulations define a C.S.A. as a written agreement:

> [U]nder which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.[20]

These rules generally provide that all intangible development costs must be shared among controlled participants in a Q.C.S.A. (the "All-Cost Rule").[21] These costs are treated as operating expenses to be included in the pool of costs to be shared. A controlled participant's share of the costs should equal its share of reasonably anticipated benefits attributable to the development of the intangible under the arrangement.[22] One issue has been whether the value of compensatory stock options should be considered part of the R&D cost pool under a Q.C.S.A.

In support of its position that such costs should be included in a C.S.A. and appropriately allocated, the Treasury issued guidance in a field service advice ("F.S.A.") in 1999.[23] On August 26, 2003, the I.R.S. issued final regulations on the stock option issue.[24] Notwithstanding voluminous comments and criticisms to the proposed

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16 White Paper, *supra* note 5, at 34.

17 These were the Basic Arm's Length Return Method ("B.A.L.R.M.") and the Profit Split Addition to the B.A.L.R.M.

18 White Paper, *supra* note 5, at 71.

19 Under the 1995 Regulations the best method rule was introduced and the concept of the arm's-length range was established. Furthermore, the 1995 Regulations created safe harbors where no adjustments are necessary, most importantly introducing the Comparable Uncontrolled Transactions ("C.U.T.") method.

20 Treas. Reg. §1.4827-7(a)(1).

21 Treas. Reg. §1.482-7.

22 Treas. Reg. §1.482-7(d)(1).

23 F.S.A. 200003010 (Oct. 18, 1999).

24 TD 9088 (Aug. 25, 2003), corrected Nov. 10, 2003. Treas. §1.482-7 is generally effective for tax years beginning after December 31, 1995. However, the provisions newly added by TD 9088 apply to stock-based compensation granted in tax years beginning after August 25, 2003.

regulations, the final regulations incorporated only minor modifications from the proposed form, a fact that becomes the central point in *Altera*.

To reiterate the S.B.C. rules, the final regulations mandate that stock-based compensation must be taken into account in determining the operating expenses subject to a C.S.A.[25] S.B.C. includes statutory and non-statutory stock options, phantom stock, and restricted stock.[26] The determination of whether S.B.C. is related to intangible development activity through a C.S.A. is made on the grant date of the S.B.C.[27] The amount of the S.B.C. expense generally is based on the amount allowed as a deduction to the controlled participant for U.S. Federal income tax purposes.[28] Foreign controlled participants are treated as U.S. taxpayers for purposes of this determination in order to bring consistency in the computations. Alternatively, an election can be made to value publicly traded stock options in the same amount, and as of the same time, so that the publicly traded stock options are reflected as a charge against income in audited financial statements or included in a footnote in such audited financial statements.[29] Such an election is available only to taxpayers preparing financial statements in accordance with U.S. generally accepted accounting principles.

"The final regulations mandate that stock-based compensation must be taken into account in determining the operating expenses subject to a C.S.A."

The I.R.S. felt that inclusion of S.B.C. was consistent with the arm's-length standard, the legislative history of Code §482, and U.S. income tax treaties.[30] The I.R.S.'s reasoning included the following:

> Treasury and the IRS believe that if a significant element of that 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.[31]

The I.R.S. rejected the idea of adopting a safe harbor.[32] It maintained a view that no basis existed for including other forms of compensation and excluding S.B.C.[33] Commentators on the proposed regulations argued that persons dealing at arm's length in real-world transactions do not take S.B.C. into account.[34]

The amendments to the final regulations were effective for S.B.C. granted in taxable years beginning on or after August 26, 2003. The preamble to the final regulations notes that these regulations are a clarification of the arm's-length standard under Code §482. Accordingly, while rules of specific application in the final regulations are prospective from the effective date, the effective date did not change the government's basic position set out in a directive that S.B.C. must be taken into account

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25 Treas. Reg. §1.482-7(d)(2)("final rule").

26 See Former Treas. Reg. §1.4827(d)(2)(i).

27 See Former Treas. Reg. §1.4827(d)(2)(ii).

28 See Former Treas. Reg. §1.4827(d)(2)(iii)(A).

29 See Former Treas. Reg. §1.4827(d)(2)(iii)(B)(1).

30 T.D. 9088, 2003-42 IRB 841, 842.

31 T.D. 9088, 2003-42 IRB 841, 843.

32 *Id.*, at 843–844.

33 *Id.*, at 841, 842.

34 *Id.*, at 841, 842.

in some reasonable form from the January 1, 1996, the effective date of the former cost sharing final regulations.

MUST S.B.C. BE INCLUDED IN THE POOL OF COSTS UNDER A Q.C.S.A.? – CASE LAW PRIOR TO *ALTERA*

Seagate

The inclusion of S.B.C. in cost sharing payments was the subject of litigation in the *Seagate* case.[35] In the settlement of that case, the government apparently conceded the stock option issue, kindling hope among taxpayers that it had changed its overall stance on the issue. Nevertheless, in a directive to examiners, the I.R.S. reaffirmed its prior position that stock option costs are properly includible in allocating costs under a cost sharing agreement.[36]

The *Seagate* case involved a motion for summary judgment by the taxpayer, Seagate Technology Inc. ("Seagate"). It argued that arm's-length principles under Code §482 do not mandate the inclusion of S.B.C. in a Q.C.S.A. Seagate was seeking a ruling that would contradict the I.R.S.'s position in F.S.A. 200003010. In effect, Seagate argued that, by its own admission, the I.R.S. had not identified a "a single actual market participant" whose transactions supported its position on compensatory stock options. Seagate compared the case in issue to *Compaq Computer Corp. v. Comm'r.*,[37] in which the taxpayer prevailed because the I.R.S. failed to establish sufficient evidence of comparable transactions. Rather, the company argued, the evidence showed that at arm's length, unrelated parties do not include the value of in-the-money options in shared costs. To this point, Seagate put forth two examples in which Federal authorities allegedly did not take into account compensatory stock options as a cost that can be compensated in their respective contracts: (i) contracts entered by the Federal Acquisition Regulations System ("F.A.R.S."), which governed contracts with all executive agencies of the Federal government for the acquisition of goods and services, including R&D during 1991 and 1992; and (ii) service contracts the United States entered into with more than 2,000 firms in each year in the period of 1990 through 1992 for the provision of R&D, testing, and engineering services. During this period, the government executed services contracts with private firms worth $19 billion, $18 billion, and $19 billion, respectively. Seagate pointed out that:

> [E]ach of these firms agreed at arm's length to conduct research and development work for the United States despite the fact that the United States refused to pay for any value of at-the-money stock options granted to their employees.

In a December 6, 1999 response to the company's request for admissions, the I.R.S. acknowledged that it could not identify a single arm's-length C.S.A., joint venture, or other similar arrangement in which one unrelated company agreed to pay a second unrelated company for any "costs" incurred with respect to the second company's granting of in-the-money stock options to its employees.

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35 *Seagate Technology Inc. v. Comm'r.*, T.C. Memo. 2000-388 ("*Seagate*").

36 "IRS Issues Directive on Stock Options and Cost Sharing Agreements," 2002 TNT 2145, Jan. 31, 2001 (dated Jan. 25, 2001).

37 *Compaq Computer Corp. v. Comm'r.*, T.C. Memo. 1999-220 ("*Compaq*").

Seagate argued that Code §482 cost-sharing regulations preclude the I.R.S. from making allocations where a taxpayer's C.S.A. is *bona fide*. Seagate Technology was a successor in interest to Conner Peripherals Inc., which merged into a *Seagate* subsidiary. Seagate noted that I.R.S. examiners had accepted Conner Peripherals' C.S.A. with foreign subsidiaries. Those examinations resulted in four "very specific" adjustments to the pool of costs, three of which were agreed to by the taxpayer. The three agreed-upon adjustments amounted to approximately $50,000 out of a total cost-sharing pool of $180 million.

Seagate asserted that, under Treas. Reg. §1.482-2A(d)(4), *bona fide* C.S.A.'s may only be subjected to allocations provided they are appropriate to reflect each participant's arm's-length share of the costs and risks of developing the property. Rather, the I.R.S. first must establish the factual predicate that allocations are necessary to reflect an arm's-length sharing of the costs and risks. In admitting unequivocally that it had no evidence to support its positions on the cost-sharing stock option issue, the I.R.S. acknowledged that the factual predicate was not demonstrated.

In addition, Seagate pointed out that the I.R.S.'s allocations for support costs related to non-integral services. Seagate argued that under Treas. Reg. §1.482-2(b)(5)(ii), the deemed arm's-length charge for non-integral services expressly excludes expenses related to the issuance of stock. Those expenses fall under the category of costs and deductions not to be considered in determining an arm's-length charge for services. Hence, the C.S.A. regulations were inconsistent with general rules under Code §482 without any reason justifying a separate rule.

The Tax Court denied the motion for summary judgment.[38] The Tax Court held that the taxpayer failed to demonstrate the absence of a genuine issue of material fact. Under the regulations, the I.R.S. is not required to be aware of arm's-length circumstances as a prerequisite to the making of a determination allocating a cost in connection with a C.S.A. As a result, the arguments made by the taxpayer – that the I.R.S. cannot apply the C.S.A. regulations calling for S.B.C. to form part of the shared costs if it cannot identify an actual C.S.A. between independent parties that includes S.B.C. – are better considered after a full trial takes place and briefs are filed.

Xilinx

At the appellate court level, the *Xilinx 2* and *Xilinx 3* cases illustrate the controversy that results from the interplay of the commensurate-with-income standard and the arm's-length standard. An opinion was issued; it was withdrawn; the holding was reversed, and two judges expressed opposite views as to the relationship between the two provisions.

The basic facts appear in the Tax Court case, *Xilinx 1*. The taxable years in issue were 1996 through 1998. In 1995, Xilinx Inc. and its Irish subsidiary entered into a C.S.A., which provided that all right, title, and interest in new technology developed by either company would be jointly owned. Under the C.S.A., each party was required to pay a percentage of the total R&D costs in proportion to the anticipated benefits to each from the new technology that was expected to be created.

38 Summary judgment is an appropriate means by which to decide a legal issue if the pleadings, admissions, and other materials, including affidavits, demonstrate that no genuine issue exists as to any material fact and a decision may be rendered as a matter of law.

Specifically, the agreement required the parties to share: (i) direct costs, defined as costs directly related to the R&D of new technology, including, but not limited to, salaries, bonuses and other payroll costs and benefits; (ii) indirect costs, defined as costs incurred by departments not involved in R&D that generally benefit R&D, including, but not limited to, administrative, legal, accounting and insurance costs; and (iii) costs incurred to acquire products or intellectual property rights necessary to conduct R&D. The agreement did not specifically address whether employee stock options ("E.S.O.'s") were a cost to be shared.

"The Tax Court initially found that parties dealing at arm's-length would not use stock option compensation as a cost and therefore concluded that the government's position was an invalid application of the then existing cost-sharing regulations."

In tax years 1997, 1998 and 1999, Xilinx Inc. deducted as business expenses approximately $41,000,000, $40,000,000 and $96,000,000, respectively, based on its employees' S.B.C. The I.R.S. contended that the S.B.C. costs of the U.S. parent should have been shared with its foreign subsidiary and issued notices of deficiency. The Tax Court initially found that parties dealing at arm's-length would not use stock option compensation as a cost and therefore concluded that the government's position was an invalid application of the then existing cost-sharing regulations. The Tax Court reasoned that the commensurate-with-income standard was intended to supplement and support the arm's-length standard; it was not intended to supplant the standard. Nothing in Code §482, its accompanying regulations, or its legislative history indicates that internal measures of cost and profit should be used to the exclusion of the arm's-length standard.

That decision was reversed by the Ninth Circuit Court of Appeals in *Xilinx 2*. The appellate court completely disregarded the "supplement and support" argument of the Tax Court and stated that despite the unequivocal language of Code §1.482-1(b)(1) of the regulations (whereby arm's-length standard is to be applied in every case), the All-Cost Rule under Code §1.482-7(d) is broad.

> [The All-Cost Rule is] explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions…we conclude the two provisions establish distinct and irreconcilable standards for determining which costs must be shared between controlled parties in [a] CSA specifically to intangible product development.[39]

According to the appellate court in *Xilinx 2*, the two provisions could not be harmonized.

The opinion in *Xilinx 2* was withdrawn and ultimately replaced by the opinion in *Xilinx 3*. In the revised opinion, the appellate court determined that the interaction of the All-Cost Rule and the arm's-length standard was at least ambiguous, and likely in conflict. On the basis of the arguments of the parties and the briefs submitted by friends of the court – including persuasive authority from international tax treaties – the court determined that the arm's-length standard was Congress' intended touchstone for Code §482. According to the court:

> The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm's length is trumped by 7(d)(1), the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.

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[39] *Xilinx 2*, at 488.

Consequently, the court refused to apply a rule of construction calling for a specific provision to control in lieu of a more general provision. The court was of the view that the purpose of Code §482 would not be furthered by ignoring the almost universal way in which unrelated parties behaved when entering a C.S.A. with another party.

An interesting sidelight of Xilinx 3 is that the company's petition for a rehearing of the case included a letter signed by former senior officials of the Organization for Economic Cooperation and Development and former tax officials of Australia, France, Germany, Japan, Mexico, Switzerland, and the United Kingdom. The letter stated that the Ninth Circuit's decision in Xilinx 2 is contrary to international norms. The rehearing petition also included a letter from an Irish tax official stating that it had contacted the U.S. Competent Authority because it was "not clear how…double taxation could be avoided" under the Ninth Circuit's prior decision.

On August 16, 2010, the I.R.S. responded to the Ninth Circuit's decision with Action on Decision 2010-003, wherein the I.R.S. reiterated its claim that the All-Cost Rule under Treas. Reg. §1.482-7(d)(1) was consistent with the arm's-length standard.[40] In the I.R.S.'s view, Treas. Reg. §1.482-7(d)(1) properly adjusted the pricing of a transaction to reflect an arm's-length result by ensuring that the controlled participants bore shares of all costs associated with their anticipated benefits.

The I.R.S. nevertheless acquiesced in the result of the decision because it viewed the decision as mooted by the 2003 amendments to Treas. Reg. §1.482-7. As explained above, these amendments expressly state that stock options are costs related to the development of intangible property that controlled taxpayers must share. The amendments apply to stock options granted in tax years beginning after August 25, 2003.

STATE FARM OR *CHEVRON* STANDARD OF REVIEW IN LIGHT OF *MAYO* CASE

***Altera* Approach**

In *Altera*, the Tax Court fully embraced the view that all tax regulations – whether issued under a specific grant of authority or under the general authority of Code §7805(a), as in the *Altera* case – are subject to the notice and comment rulemaking requirements under the A.P.A. For some, this conclusion may be surprising. However, it follows a trend in which the grant of authority given to the I.R.S. is accompanied by an expectation of responsibility that prevents the I.R.S. from being arbitrary and capricious. Based on the holding in *Altera*, Microsoft has announced that it may follow suit.[41]

The court in *Altera* ruled that all final administrative rules – *viz.*, regulations – issued under the Treasury's general rulemaking authority based on Code §7805(a) are

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40 Compare AOD 2010-003, IRB 2010-33 (Aug. 16, 2010), 2010 AOD LEXIS 6, at 7-8, with *Xilinx 2*, at 491 and *Xilinx 1*, at 54.

41 In defense of a summons enforcement action in Federal District Court (*U.S. v. Microsoft, W.D. Wash.*, No. 2:15-cv-00102, notice filed August 6, 2015). See *International Tax Monitor*, No. 156 (Aug. 10, 2015).

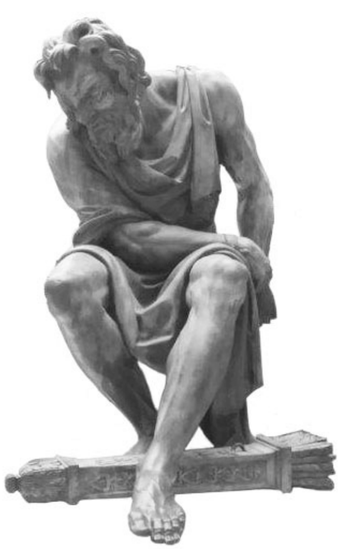
legislative rules because they are intended to have the force of law.[42] Moreover, it was clear to the Tax Court that the Treasury Department intended to exercise that power when it issued the C.S.A. regulations directed at S.B.C. Accordingly, it held that the final rule is subject to the notice and comment rulemaking process outlined in A.P.A. §533.

More than one standard of review can apply under the A.P.A. The task of the Tax Court in *Altera* is to determine the standard that is applicable. In the case, the taxpayer contended that the final rule was arbitrary and capricious under the so-called *State Farm* standard. In comparison, the I.R.S. countered that rule was valid based on the so-called *Chevron* test. In its decision, the Tax Court accepted neither position completely. It held the distinction to be irrelevant. According to the court, the *State Farm*[43] standard of review must be followed in applying the *Chevron*[44] step two test:

> * * * whether *State Farm* or *Chevron* supplies the standard of review is immaterial because *Chevron* step 2 incorporates the reasoned decision making standard of *State Farm*, see *Judulang v. Holder*, 565 U.S. at ___ n.7, 132 S. Ct. at 483 (stating that, under either standard, the 'analysis would be the same, because under *Chevron* step two, we ask whether an agency interpretation is `arbitrary or capricious in substance' (quoting *Mayo Found.*, 562 U.S. at 53)) * * * . Because the validity of the final rule turns on whether Treasury reasonably concluded that it is consistent with the arm's-length standard, the final rule must-in any event-satisfy *State Farm*'s reasoned decision making standard.[45]

Further, referring to the *State Farm* standard of review, the Tax Court held that:

> [B]y failing to engage in any fact finding, Treasury failed to 'examine the relevant data', *State Farm*, 463 U.S. at 43, and * * * failed to support its belief that unrelated parties would share stock-based compensation costs in the context of a QCSA with any evidence in the record. Accordingly, the final rule lacks a basis in fact.[46]



The Tax Court held that the final rule failed to satisfy *State Farm*'s reasoned decision-making standard and for that reason was invalid.

***State Farm* Standard**

The standard discussed in *Altera*, is one that is mandated on all Federal agencies that promulgate rules pursuant to a legislative mandate. Thus, whether the rule is a tax rule in a Treasury regulation or a Federal Communications Commission rule that applies to broadcast media, the same standard applies in determining whether the process set forth in the A.P.A. has been followed and whether the rule reflects action that is arbitrary and capricious.

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42 *Am. Mining Cong. V. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)

43 *State Farm*.

44 *Chevron*.

45 *Altera*, at 68.

46 *Id.*, at 71.

The Supreme Court, in a nontax context, stated that an agency's notice of rulemaking must:

> * * * articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made * * * [and] must cogently explain why it has exercised its discretion in a given manner.

An agency rule is invalid as arbitrary and capricious if it:

> * * * entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[47]

State Farm involved a challenge to the efforts of the newly-elected Reagan administration to deregulate the area of passive restraints for automobiles.[48] The National Highway Traffic Safety Administration ("N.H.T.S.A."), to which the Secretary has delegated his authority to promulgate safety standards, rescinded the requirement of Modified Standard 208 that new motor vehicles produced after September 1982 be equipped with passive restraints (automatic seatbelts or airbags) to protect the safety of the occupants of the vehicle in the event of a collision. The safety requirements that the N.H.T.S.A. rescinded had been established in the implementation of:

> [T]he National Traffic and Motor Vehicle Safety Act of 1966 (Act). The Act, created for the purpose of 'reduc[ing] traffic accidents and deaths and injuries to persons resulting from traffic accidents,' directs the Secretary of Transportation or his delegate to issue motor vehicle safety standards that 'shall be practicable, shall meet the need for motor vehicle safety, and shall be stated in objective terms.' In issuing these standards, the Secretary is directed to consider 'relevant available motor vehicle safety data,' whether the proposed standard 'is reasonable, practicable and appropriate' for the particular type of motor vehicle, and the 'extent to which such standards will contribute to carrying out the purposes' of the Act.[49]

The Court held that the N.H.T.S.A.'s rescission of the safety requirements was subject to review under the arbitrary or capricious standard because the safety standards had been defined by informal rulemaking.[50] The Court based its application of such review standard on analysis in an earlier case, *Overton Park*.[51] In particular, similar to *Overton Park*, the Court's analysis retained the uncertain distinction between the substance of the agency decision and its decision-making process:

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47 *State Farm*, at 43 and 48 (1983). See *Dominion Res., Inc. v. U.S.* 681 F3d 1313 (Fed. Cir. 2012) (holding paragraph in detailed Treas. Reg. under Code §263A(f) invalid because the Treasury provided "no explanation for" its inclusion of rule stated in paragraph).

48 *State Farm*, 463 U.S. 29, 36-37 (1983).

49 *Id.*, at 33-34 (alteration in original) (citations omitted) (quoting 15 U.S.C. §§1381, 1392(a), 1392(f)(1), 1392(3)-(4) (1976 & Supp. V 1981)).

50 *Id.*, at 41.

51 *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 413-416 (1971) ("*Overton Park*").

> The scope of review under the 'arbitrary and capricious' standard is narrow and a Court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a '*rational connection between the facts found and the choice made*.' In reviewing that explanation, we must 'consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.' Normally, an *agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise*. The reviewing Court should not attempt itself to make up for such deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given. We will, however, 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.'[52] [Emphasis added.]

"The scope of review under the 'arbitrary and capricious' standard is narrow and a Court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action."

While applying this standard, the Court rejected the conclusion that the agency's rescission was unlawful:

> The failure of Congress to exercise its veto might reflect legislative deference to the agency's expertise, and does not indicate that Congress would disapprove of the agency's action in 1981. And even if Congress favored the Standard in 1977, it - like NHTSA - may well reach a different judgment, given changed circumstances four years later.[53]

I.e., in the Court's view, the agency's rescission had not exceeded the scope of its legal authority in applying the *Overton Park* terminology of review. In other words, the Court rejected a claim that rescission was barred under the first step of *Chevron*, as discussed below.

The Court then considered the adequacy of the agency's decision-making process. The Court concluded, unanimously, that the agency violated the arbitrary or capricious standard because it had failed to consider whether to mandate the exclusive use of either airbags or the continuous seatbelt. This was arbitrary or capricious. The Court held that:

> The first and most obvious reason for finding the rescission arbitrary and capricious is that NHTSA apparently gave no consideration whatever to modifying the Standard to require that airbag technology be[ing] utilized.[54]

The agency rescinded the requirement without assessing whether safety would be promoted by simply requiring all manufacturers to use the same safety technology.

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52 *State Farm*, 43 (citations omitted) (quoting *Burlington Truck Lines, Inc. v. U.S.*, 371 U.S. 156, 168 (1962); *Bowman Transp., Inc. v. Ark.-Best Freight Sys., Inc.*, 419 U.S. 281, 285-86 (1974); *Overton Park*, 401 U.S. at 416, and *SEC v. Chenery Corp*, 332 U.S. 194, 196 (1947) ("*Chenery 1*"); *Camp v. Pitts*, 411 U. S. 138, 411 U. S. 142-143 (1973) (*per curiam*)).

53 *State Farm*, at 45.

54 *Id.*, at 46.

The statute, in other words, defined the factors that the agency had to consider in making its regulatory decisions. "The agency has failed to supply the requisite 'reasoned analysis' in this case."[55]

The arbitrary or capricious review standard the Court applied in *State Farm* was much more elaborate than in *Overton Park*. The *State Farm* decision retained a path to challenge an administrative regulation in terms of process but was directed at the substance of the rule. At one level, uncertainty remained about whether the standard to be applied in determining whether agency action is arbitrary or capricious is concerned only with the agency's decision-making process, yet at another level, the standard seemed to reflect the Court's view that the agency's substantive decision was erroneous because it did not address certain factors that were found to be of importance. In other words, the terminology of the Court was process, the holding suggested substance.[56]

In sum, *State Farm* retained the core view that in the first place the content of law for an agency may be defined by Congress. In the absence of clearly defined law, the agency's application of the law may be subjected to review under the arbitrary or capricious standard.[57] That standard is focused on the agency's decision-making process. *State Farm* thus stands for a process-oriented review standard of an agency's action by the courts, but appropriate process is in the eye of the beholder.

***Chevron* Standard**

In *Chevron*, the Court laid down two main principles: First, as long as there is administrative guidance on a statute, the Court is required to defer to an agency's interpretation as opposed to apply its own interpretation of the rule. Second, in reviewing the agency's guidance, the standard to be applied is whether the Court deems it a permissible interpretation of the rule.

In *Chevron*, the Court reviewed a regulation promulgated by the Environmental Protection Agency ("E.P.A.") that broadly defined a stationary source under the Clean Air Act. This narrowed the circumstances under which modifications of an existing source would trigger the stringent requirements for a new stationary source.[58] Accordingly, the Court proceeded to the second step of the analysis, the step at which deference is owed to an agency's interpretation.

In reaching its decision, the Supreme Court established a two-part test, commonly referred to as the *Chevron* two-step, to be applied when a court is reviewing an agency's statutory interpretation:[59]

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of

55 *Id.*, at 56.

56 To illustrate, if the argument that was not considered by the agency was viewed by the Court to be frivolous, the likelihood of striking down the rule would be remote in the view of the authors.

57 *State Farm*, at 42-43 (majority opinion).

58 *Chevron*, at 840 (describing the netting out effect of the so-called bubble concept).

59 *Id.*, at 842-43 (omitting Fn. 10).

> the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.[60] If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply [61]impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a *permissible construction of the statute*.[62] [Emphasis added.]

Thus, a reviewing court must affirm an agency's interpretation even if it is not the best interpretation of a statute or the interpretation that the court would have devised. The court must defer to the agency's interpretation even if it is not the meaning that the court would give to the statute. In addition, the court is not permitted to substitute its own judgment for that of the agency if the agency's interpretation is allowed by the statute. The Court stated that "the Court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the Court would have reached if the question initially had arisen in a judicial proceeding."[63] In other words, the court must defer to the agency's interpretation unless that interpretation is unreasonable. In essence, this refined the holding in *State Farm*, by stating that the agency's decision will be affirmed where a decision to proceed in one of two or more ways is relatively even among the alternatives. It is only when the choice is not close that the action may be struck down as arbitrary or capricious. Egregious decision making by an administrative agency of the Federal government will not be affirmed.

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60 *Id.*, at Fn. 9:

> The judiciary is the final authority on issues of statutory construction, and must reject administrative constructions which are contrary to clear congressional intent. See, *e.g.*, *FEC v. Democratic Senatorial Campaign Committee*, 454 U.S. 27, 454 U.S. 32 (1981); *SEC v. Sloan*, 436 U.S. 103, 436 U. S. 117-118 (1978); *FMC v. Seatrain Lines, Inc.*, 411 U.S. 726, 411 U.S. 745-746 (1973); Volkswagenwerk v. FMC, 390 U. S. 261, 390 U. S. 272 (1968); *NLRB v. Brown*, 380 U.S. 278, 380 U.S. 291 (1965); *FTC v. Colgate-Palmolive Co.*, 380 U. S. 374, 380 U. S. 385 (1965); *Social Security Board v. Nierotko*, 327 U.S. 358, 327 U.S. 369 (1946); *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 285 U.S. 16 (1932); *Webster v. Luther*, 163 U.S. 331, 163 U.S. 342 (1896). If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law, and must be given effect.

61 *Id.*, at 843.

62 *Id.*, at Fn. 11:

> The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding. *FEC v. Democratic Senatorial Campaign Committee*, 454 U.S. at 454 U.S. 39; *Zenith Radio Corp. v. United States*, 437 U.S. 443, 437 U.S. 450 (1978); Train v. Natural Resources Defense Council, Inc., 421 U. S. 60, 421 U.S. 75 (1975); *Udall v. Tallman*, 380 U.S. 1, 380 U. S. 16 (1965); *Unemployment Compensation Comm'n v. Aragon*, 329 U.S. 143, 329 U.S. 153 (1946); *McLaren v. Fleischer*, 256 U.S. 477, 256 US. 480-481 (1921).

63 *Id.*, at 843 n.11.

The Court's motivation for granting deference to agencies came from the Court's view that statutory ambiguity means that Congress has delegated interpretive authority to agencies[64] and not courts.[65] The Court provided two reasons for this rule of deference: agency expertise and the superior democratic accountability of agencies when compared to courts.[66]

The second part of the Court's analysis, "whether the agency's answer is based on a permissible construction of the statute"[67] or what materials a court is required to consider in making that determination, is no easy undertaking. Part of the Court's discussion suggested that the agency's interpretation was lawful because the agency considered the proper factors – "the economic interest in permitting capital improvements to continue and the environmental interest in improving air quality" – when it established the regulation.[68]

The Court upheld the E.P.A.'s definition of the term "stationary source" and reversed the D.C. Circuit's judgment.[69] The Supreme Court concluded that:

> [T]he Administrator's interpretation represents a reasonable accommodation of manifestly competing interests and is entitled to deference: the regulatory scheme is technical and complex, the agency considered the matter in a detailed and reasoned fashion, and the decision involves reconciling conflicting policies.[70]

Chevron in Tax Cases

Chevron, which was not a tax case, was decided only five years after the Court's decision in *National Muffler Dealers Association v. U.S.*[71] In *National Muffler*, the Court held that tax regulations promulgated by the I.R.S. should hold up to a traditional rule as the standard of review and set out factors to determine the reasonableness of a Treasury regulation. These factors include:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether

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64 *Id.*, at 843-844:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by Treas. Regulation. Such legislative Treas. Regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a Court may not substitute its own construction of the statutory provision for reasonable interpretation made by the administrator of the agency. (Footnote omitted.)

65 *Id.*, at 842, 843.

66 *Id.*, at 844-45, 865-66; and *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*, 120 S. Ct. 1291, 1300 (2000).

67 *Chevron*, at 843.

68 *Id.*, at 851.

69 *Id.*, at 866.

70 *Id.*, at 865.

71 *National Muffler Dealers Assn., Inc v. United States*, 440 U.S. 472 (1979) ("*National Muffler*").

> the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent.[72]

Under the traditional rule "Courts customarily defer to a treasury regulation that implements the congressional mandate in some reasonable manner"[73] and "should not overrule such a regulation 'except for weighty reasons'."[74]

Arguably, the traditional rule, not the *Chevron* rule, should apply to tax regulations. However, as the Seventh Circuit stated in *Bankers Life & Cas. Co. v. U.S.*:[75]

> While the two approaches articulate the level of deference differently, they both come down to one operative concept – reasonableness. Thus, *Chevron* and the traditional rule constitute two different formulations of a reasonableness test. There may be some subtle difference in the phrasing of each framework, but we should be wary of attempts to discern too many gradations of reasonableness. * * * Viewed from this perspective at least, the supposed gap between *Chevron* and the traditional rule is a distinction without a difference.

In *Mayo Found. for Med. Educ. & Research v. U.S.*,[76] the Supreme Court was asked to determine whether participants in residency programs for doctors were students undergoing training for purposes of the imposition of Social Security taxes. If so, no tax was due with regard to payments made by the hospitals to the residents. If not, tax would be imposed on the hospitals and the participants. The residents in the program received formal educational training and in addition spent the bulk of their time – 50 to 80 hours per week – caring for patients.

The statute defined "employment" as "any service...performed...by an employee for the person employing him."[77] The general rule, however, was subject to an exception that excluded payments in connection with any "service performed in the employ of...a school, college, or university...if such service is performed by a student who is enrolled and regularly attending classes at [the school]."[78]

Dating back to 1951, the Treasury Department construed the student exception to be applicable to students working for schools as an incident to and for the purpose

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72 *National Muffler*, at 477.

73 *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554, 560-61, 111 S.Ct. 1503, 1507-08, 113 L.Ed.2d 589 (1991) (citing *National Muffler*, 440 U.S. 472, 476-77, 99 S.Ct. 1304, 1306-07, 59 L.Ed.2d 519 (regulation may have particular force if substantially contemporaneous construction of statute by those presumed to have been aware of Congressional intent)); see also *Chevron*, 467 U.S. 837, 843, 104 S.Ct. 2778, 2781-82, 81 L.Ed.2d 694 (1984).

74 *Bingler v. Johnson*, 394 U.S. 741, 750, 89 S.Ct. 1439, 1445, 22 L.Ed.2d 695 (1969) (citing *Comm'r v. South Texas Lumber Co.*, 333 U.S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831 (1948)).

75 *Bankers Life & Cas. Co. v. U.S.*, 142 F3d 973, 981–982 (7th Cir. 1998).

76 *Mayo Found. for Med. Educ. & Research v. U.S.*,131 S. Ct. 704 (2011).

77 Code §3121(b).

78 Code §3121(b)(10).

of pursuing a course of study. In 2004, the Treasury Department issued regulations providing that the services of a full-time employee – which includes an employee normally scheduled to work 40 hours or more per week – are not incident to and for the purpose of pursuing a course of study. An example in the regulations concludes that a medical resident whose normal schedule requires him to perform services 40 or more hours per week as a resident is not a student.

The Mayo Foundation filed suit asserting that the regulation was invalid. The District Court upheld the claim[79] but the 8th Circuit Appellate Court reversed,[80] applying the holding in *Chevron*. The Supreme Court upheld the reversal,[81] stating:

"'The power of an administrative agency to administer a congressionally created...program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.'"

> The principles underlying our decision in *Chevron* apply with full force in the tax context. *Chevron* recognized that '[t]he power of an administrative agency to administer a congressionally created...program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.' * * * It acknowledged that the formulation of that policy might require "more than ordinary knowledge respecting the matters subjected to agency regulations.' * * * Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the * * * '[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems' * * *. We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations. (Citations omitted.)

In *National Cable & Telecommunications Association v. Brand X Internet Services*,[82] the Supreme Court held that a court must apply the *Chevron* rule, even if, before the agency adopted the regulation, the court construed the underlying statute in a way differing from the agency construction embodied in the regulation. According to the Supreme Court:

> A Court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior Court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion. This principle follows from Chevron itself. Chevron established a "presumption that Congress, when it left ambiguity in a statute in a way that was intentionally meant for implementation by an agency, understood that the ambiguity would be resolved, first and foremost, by the agency, and desired the agency (rather than the Courts) to possess whatever degree of discretion the ambiguity allows." * * * [Smiley v. Citibank (South Dakota), N. A., 517 U.S. 735, 740–741

79 *Mayo Found. for Med. Educ. & Research v. U.S.*, 503 F.Supp.2d 1164, (D. Minn, 2007).

80 *Mayo Found. for Med. Educ. & Research v. U.S.*, 568 F.3d 675 (8th Cir. 2009).

81 *Mayo Found. for Med. Educ. & Research v. U.S.*, 131 S.Ct. 704 (2011).

82 *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967, 981 (2005).

(1996).] Yet allowing a judicial precedent to foreclose an agency from interpreting an ambiguous statute, as the Court of Appeals assumed it could, would allow a Court's interpretation to override an agency's. Chevron's premise is that it is for agencies, not Courts, to fill statutory gaps. * * * The better rule is to hold judicial interpretations contained in precedents to the same demanding *Chevron* step one standard that applies if the Court is reviewing the agency's construction on a blank slate: Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.

***Chevron* – Bottom Line**

The Supreme Court has provided little guidance as to how a court should evaluate whether the agency's interpretation is "permissible" or "reasonable" under *Chevron* step two. Oftentimes, in determining whether the agency's interpretation is reasonable, a court's focal point will be given to the purpose and goal of a statute. For example, in *Chevron*, the Supreme Court noted that the agency's interpretation "of the term 'source' is a permissible construction of the statute" in light of the statute's goals "to accommodate progress in reducing air pollution with economic growth."[83] Put in other words, "about all the Court can do is determine whether the agency's action is rationally related to the objectives of the statute containing the delegation."[84] This approach is followed by many courts. For example, in *Natural Resources Defense Council, Inc. v. EPA*, the D.C. Circuit noted that, under step two of *Chevron*, "the agency's interpretation must be sustained if it is reasonable in light of the language, legislative history, and policies of the statute."[85] In that case, the D.C. Circuit upheld an E.P.A. regulation concerning the Clean Water Act, noting that "[w]e are persuaded that E.P.A.'s reading of the statute, while not the only plausible one, is reasonable." First, the court determined the language of the statute to be "confusing." At step two, the court looked at the agency interpretation and compared it with the overarching goals of the statute to conclude that the agency's guidance was a permissible interpretation of the ambiguous statutory provision.

Kennecott Utah Copper Corp. v. United States Department of the Interior provides another example of this approach to *Chevron* step two.[86] The Department of the Interior promulgated regulations concerning when the statute of limitations for damages for certain oil spills would begin to run. The court determined that applying step two of *Chevron* the agency's construction was "not a reasonable interpretation of the [ambiguous] statute, viewed with an eye to its structure and purposes." The purpose of setting a limitation was to provide the industry with a certain level of comfort that it will not be brought to court for actions taken in the past. Hence, prolonging the limitation as set forth under the agency's regulations was construed as not compliant with the identified goal.

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83 *Chevron*, at 866.

84 *Mueller v. Reich*, 54 F.3d 438, 442 (7th Cir. 1995).

85 *Natural Resources Defense Council, Inc. v. EPA*, 822 F.2d 104, 111 (D.C. Cir. 1987).

86 *Kennecott Utah Copper Corp. v. United States Department of the Interior*, 88 F.3d 1191 (D.C. Cir. 1996).

One reason for the lack of clarity lies in the fact that once a reviewing court reaches the second step of the *Chevron* standard, the agency interpretation of the statute is usually sustained, often in a perfunctory way. With perhaps one exception, *AT&T Corp. v. Iowa Utilities Bd.*,[87] commentators have observed that the Supreme Court has never invalidated an agency interpretation of a statute at step two of *Chevron*.[88] The lower court's *Chevron* step two cases follow a similar, though not as overwhelming, pattern.[89] Consequently, an explanation of exactly what a court should examine at step two can rarely be found. Even if so, it is then hard to evaluate the relative importance of the various factors that courts can rely on when they uphold interpretations given the limited number of cases.

On a stand-alone basis, the *Chevron* step two test seems to constitute a rule-oriented standard of review for courts as opposed to the process-driven approach under the *State Farm* standard, *i.e.*, whether the agency gathered data relevant to the issue, sufficiently took into account comments, etc. Under the *Chevron* step two test, courts must defer to the agency's reasoning and deem the administrative guidance permissible as long as (i) a statute is ambiguous and (ii) the rule allows a statutory goal to be met. Absent further clarification, the bottom line is that the agencies succeed in cases where the *Chevron* test was applied.

The next question now is how *State Farm* and *Chevron* interact, *i.e.*, whether one can be performed without taking into consideration principles laid down for the other.

ALTERA CONCLUSION

At one level, the decision in *Altera* results from hubris on the part of the I.R.S. Perhaps, if the I.R.S. adopted a process by which it considered the interrelation of the commensurate-with-income standard and the arm's-length standard, it is possible that the Tax Court would not have reached *Chevron* step two analysis. By not providing analysis, the I.R.S. made it easy for the Tax Court to apply its own judgment to the issue. However, even if the process were followed by the I.R.S., an agency's reasoning can be defective to such an extent that the presumption of correctness in the regulation is vitiated without violating the *Chevron* standard.

As it turned out, the taxpayer's support for its position was largely empirical, and stood on the shoulders of the empirical case built in *Xilinx* for exclusion of S.B.C. from a cost pool in a cost sharing arrangement. This empirical evidence consisted of a number of joint venture and other collaboration agreements submitted by commentators to the proposed 2003 C.S.A. regulations.

These agreements included certain elements of labor compensation that parties to the agreements consented to share, but did not include S.B.C. among those expenses. Agreements from the software industry, comparable to the industry in

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87 *AT&T Corp. v. Iowa Utilities Bd.*,119 S.Ct. 721, 734-36 (1999).

88 See Bressman, Lisa Schultz, "Schechter Poultry at the Millennium: A Delegation Doctrine for the Administrative State," *Yale Law Journal*, Vol. 109 No. 6 (Apr. 2000): 1399, 1400.

89 See Kerr, Orrin S., "Shedding Light on Chevron: An Empirical Study of the Chevron Doctrine in the U.S. Courts of Appeals," *Yale Journal on Regulation*, Vol. 15, No. 1 (1998).

which *Altera* operated during the years at issue, were produced and viewed as sufficiently comparable to the Altera arrangement. These agreements proved persuasive in *Altera*, and served to amplify the effect of the failure of the Treasury to consider the submissions from commentators to the proposed 2003 C.S.A. regulations. Neither the Treasury, as part of its finalization of the 2003 regulations, nor the I.R.S. in *Altera* produced evidence of an agreement between third parties that included stock option costs. Proof of arm's-length behaviour with respect to stock option expense was therefore delivered in the form of a negative empirical result.

"The I.R.S. position is inherently simple to identify – if S.B.C. costs are an expense for financial statement purposes, S.B.C. costs should be an expense for income tax purposes that is properly part of a cost pool."

The empirical evidence was bolstered by economic analysis submitted as commentary to the proposed 2003 C.S.A. regulations. First, this evidence was used to demonstrate that unrelated parties would not share stock option compensation costs "because the value of stock-based compensation is speculative, potentially large, and completely outside of the control of the parties." Second, the notion that S.B.C. costs are are borne by a company was successfully defeated with analysis submitted in response to the proposed 2003 regulations by well-known economists William Baumol and Burton Malkiel, who concluded that "there is no net economic cost to a corporation or its shareholders from the issuance of stock-based compensation."

The Tax Court was persuaded that not only is S.B.C. not shared between cooperating independent parties, it held that stock-option expense should not be considered as an element of the comprehensive set of costs considered by the Treasury to be "relevant costs" in a Q.C.S.A.

The I.R.S. position is inherently simple to identify – if S.B.C. costs are an expense for financial statement purposes, S.B.C. costs should be an expense for income tax purposes that is properly part of a cost pool. The problem with this approach is that S.B.C. costs for financial accounting purposes measure the effect of dilution in earnings per share as a result of the of the S.B.C. arrangement. However, it is the shareholder group that bears this cost, not the corporation. It is recognized that the corporation receives a compensation deduction at the time of exercise. However, that simply flows from the character of the income reported by the employee and keeps the global income and expense system in stasis. One party performs services and reports income and the other party employs the service provider and has a deduction or an increase in the basis of an asset, whichever is appropriate.

Another troubling aspect with the I.R.S. position is that the cost of S.B.C. is not directly related to the value of the services performed. Rather, it is affected by the growth in value of the stock between the grant date and the exercise date, assuming the exercise price is equal to fair market value on the date of the grant.

To illustrate, assume that a janitor is assigned to maintain the building in which a participant to a C.S.A. conducts activities related to the C.S.A. Assume further that he benefits from an option issued many years ago when the value at grant date was \$25 and the exercise price was \$25. At exercise of the the option, the janitor will have \$75 of income per share if the value of each share at exercise date is \$100. At the same time, assume that a newly-hired divisional vice president heads the C.S.A. project for the same participant. Assume further that, because he is newly hired, the divisional vice president holds options with a grant date value of \$95 and an exercise price of \$95. At exercise of the option on the same day as the janitor, the divisional vice president will have $5 of income per share. While the divisional vice president may hold many more shares than the janitor, on a per share bases, the janitor's services are of significantly greater value than the services of the divisional vice president.

"The I.R.S. had only one principal argument to raise – it relied on the commensurate-with-income standard, and did not present any expert opinion."

The result in the example is is extreme, but illustrates the weakness in the I.R.S. position and the reason why, when a C.S.A. is created between independent parties, S.B.C. costs are not taken into account. The expense does not reduce the wealth of the corporation and the S.B.C. is not linked to the value of services performed. The Federal government follows the same rule when reimbursing contractors operating under cost-plus arrangements. Because independent parties and the Federal government do not share S.B.C. costs, the I.R.S. found itself in a deep logic hole when arguing its position for partial summary judgment in *Altera*.

Not wishing to focus on (i) the absence of any reduction in a company's wealth resulting from an S.B.C. arrangement, (ii) the disconnect between the value of services performed and the amount of the S.B.C. income and expense, and (iii) the actions of truly independent parties, the I.R.S. had only one principal argument to raise – it relied on the commensurate-with-income standard, and did not present any expert opinion that supported the position that S.B.C. must be included in the cost pool of a Q.C.S.A. to achieve an arm's-length result.

Among litigators there is an old saying that in setting strategy for arguing a case, a litigator faces a choice of three possible actions. If the client benefits from favorable law but faces unfavorable facts, the litigator should strongly argue the importance of the law. On the other hand, if the client benefits from favorable facts but faces unfavorable law, the litigator should strongly argue the importance of the facts. Finally, if neither the law nor the facts benefit the client, the litigator should bang his fists loudly on the table when making arguments. Readers are invited to draw their own conclusion when reviewing the litigation strategy of the I.R.S. in *Altera*.