Altera Upends Established Roles of Government Branches

by James "Jim" Dawson

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In this article, Dawson examines the problematic consequences of the Ninth Circuit's recent precedent-setting decision in *Altera*.

It is a legal axiom that Congress enacts the law and the executive branch enforces the law. However, *Altera*[1] demonstrates that the Internal Revenue Code can be fashioned by the executive branch under the guise of interpretation through regulations. This anomaly is a result of the *Chevron* doctrine and the judicial reluctance to enforce the Administrative Procedure Act (APA) in connection with title 26 and its regulations.[2] Until this quandary is resolved, *Altera* raises the question whether our legal truism is in jeopardy.[3]

The statute under scrutiny is section 482, which was amended in 1986 by adding the following second sentence: "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 commensurate with income standard is an internal allocation process, distributing costs in proportion to the income enjoyed by each related taxpayer.

The first sentence of the statute,[4] in a previous iteration, was enacted in 1928. Since 1934 the IRS had consistently interpreted through its regulations that transactions between commonly controlled taxpayers must be on parity with prices that would prevail in transactions between uncontrolled taxpayers acting at arm's length — that is, the arm's-length standard based on third-party transactions. As a result of the 1986 amendment, Treasury in effect believed the commensurate with income standard to be consistent with the arm's-length standard and therefore a comparability analysis must be performed when possible. It also suggested, however, a "clear and convincing evidence" standard for comparable transactions, indicating that a comparability analysis would rarely be possible in some situations.[5] Whether the commensurate with income standard constituted a modification to the arm's-length standard or a competing standard became the center of dispute.

[1] *Altera Corp. v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019).

[2] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984); *Motor Vehicle Manufacturers Association of the United States Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983); *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44, 55 (2011).

[3] The discussion points in this article were first addressed in the Sixth Annual University of San Diego of Law Transfer Pricing Symposium (May 9-10, 2019). In a moot court case, the author of this article and Roderick Donnelly of Morgan and Lewis LLP appeared before a fictional panel of the Ninth Circuit. The author represented the government and Donnelly represented the taxpayer. Donnelly also represented Cisco Systems Inc., which filed as amicus curiae in *Altera*. Later, Bloomberg Law News Insight published an article that discusses points made in this article. *See* Edward Froelich, "Altera v. Commissioner — Administrative Procedure Act Under Siege?" (Aug. 2, 2019).

[4] The first sentence of section 482 reads 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.

[5] *See* Notice 88-123, 1988-2 C.B. 458, 474-475, 478. *See Altera*, 926 F.3d at 1071.

The *Altera* court looked to *Chevron* and the APA for the answer.

In *Altera*, both the majority and dissenting opinions agreed, to a point, that the issue at hand — allocation of employee stock compensation to a cost-sharing arrangement — had not been directly contemplated by the drafters when the statute was amended in 1986.[6] After that, the majority and the dissent diverged. The disagreement was attributable to different views regarding when and how broadly *Chevron* and the APA should apply. Stated differently: Which analysis comes first — *Chevron* or the APA? The majority applied the *Chevron* test broadly and the APA narrowly,[7] finding the regulation to be based on a permissible construction of the statute and therefore valid. The dissent applied the APA broadly and *Chevron* narrowly, thus finding the regulation procedurally flawed.

Under *Chevron*, if the statute is silent or ambiguous on an issue,[8] the agency's interpretation is given deference if "it is based on a permissible construction of the statute." That is, it need not be a perfect interpretation or even the best one.[9] The legislative history, the statutory structure, and "other traditional aids of statutory interpretation" are examined to ascertain the reasonableness of the agency's interpretation.[10] A reasonable interpretation is "a permissible construction . . . that is not arbitrary, capricious, or manifestly contrary to the statute."[11] Moreover, the majority stressed that an important factor regarding the issue of deference is whether "it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority."[12] Treasury opened the regulations to public comment, a move that is typically indicative of agency action that carries the force of law. If the regulation was found to be a reasonable interpretation, the notice and comment under the APA would in effect allow that interpretation to carry the force law. Thus, the APA would be used as a shield and not the sword to pierce the regulation.

Congress's purpose in amending section 482 in 1986 was therefore the key to resolving the issue.[13] That purpose was parity. The majority found that the 1986 amendment and its legislative history reflected Congress's recognition that the traditional arm's-length standard did not serve the purpose of section 482. The congressional objective for amending section 482 was to ensure that income follows economic activity.[14] Thus it was reasonable for Treasury to believe that Congress intended a departure from analysis of comparable transactions as the exclusive means of

[6] *Altera*, 926 F.3d at 1072: "Neither the Tax Reform Act nor the implementing regulations specifically addressed allocation of employee stock compensation, which is the issue in this dispute. However, that omission was unsurprising given that the practice did not develop on a major scale until the 1990s."

[7] The majority viewed the applicability of the two tests as follows: "*State Farm* is used to evaluate whether a rule is procedurally defective as a result of flaws in the agency's decisionmaking process. *Chevron*, by contrast, is generally used to evaluate whether the conclusion reached as a result of that process — an agency's interpretation of a statutory provision it administers — is reasonable." *Altera*, 926 F.3d at 1075.

[8] The first stumbling block was whether the statute even applied. That is, whether a cost sharing agreement was an intangible. The majority found that the cost sharing agreement inherently was a transfer of intangibles, *i.e.*, a transfer of future distribution rights to intangibles, but whether the commensurate with income standard applied was not clear from the language of the statute. *Altera*, 926 F.3d at 1076.

[9] "Agency inconsistency is not a basis for declining to analyze the agency's interpretation under the *Chevron* framework." In *Mayo Foundation*, the agency changed its position that it had held for over 50 years. ("It is immaterial under *Chevron* that a 'regulation was prompted by litigation.'") *Mayo Foundation*, 562 U.S. at 55.

[10] The agency's interpretation is examined "in light of the statute's text, structure and purpose." *Altera*, 926 F.3d at 1076.

[11] *Chevron*, 467 U.S. at 844.

[12] *Altera*, 926 F.3d at 1075-1076, citing *United States v. Mead Corp.*, 533 U.S. 218, 226-227 (2001).

[13] *Altera*, 926 F.3d at 1076.

[14] The majority focused on the legislative history (H.R. Rep. No. 99-426), finding that "the clause was intended to correct a 'recurrent problem' — the absence of comparable arm's-length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's-length concept in the absence of comparables." The House report makes clear that the committee intended the commensurate with income standard to displace a comparability analysis if comparable transactions cannot be found:

> A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. . . . Multinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries. . . . There are extreme difficulties in determining whether the arm's-length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation . . . be commensurate with the income attributable to the intangible. . . . The committee intends to make it clear that industry norms or other unrelated-party transactions do not provide a safe-harbor minimum payment for related-party intangible transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms.

Altera, 926 F.3d at 1070-1071.

achieving an arm's-length result. Thus, Treasury's interpretation "was not arbitrary, capricious, or manifestly contrary to the statute, *and was permissible under Chevron*."[15]

The majority turned next to the APA to determine whether during the rulemaking process the IRS had examined the relevant data and articulated a satisfactory explanation for its action, including a rational connection between the facts found and the choice made (otherwise known as reasoned decision-making).[16] In its performance of the *Chevron* analysis, the majority had already determined by reviewing the legislative history that the commissioner had constructed a regulation mandated by Congress.[17] Thus, the APA was narrowly limited by expanding the record to include the purpose behind the statute (as set forth in the legislative record) even if not fully set forth in the administrative record. The majority stated:

> Treasury reasonably interpreted congressional intent in the 1986 amendments as permitting it to dispense with a comparable transaction analysis in the absence of actual comparable transactions. Its interpretation was all the more reasonable given, as we have discussed, that the arm's-length standard has historically been understood as more fluid than Altera suggests. Because *Chenery* does not require agencies to provide "exhaustive, contemporaneous legal arguments to preemptively defend its action," its references to the 1986 amendments provide an adequate ground for its determination.[18] [Citations omitted.]
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> Though it could have been more specific, Treasury "articulated a rational connection" between its decision and these industry standards. [Citations omitted.] Presuming that Treasury was authorized to dispense with a comparability analysis, making the economic behavior of uncontrolled taxpayers irrelevant, Altera does not offer any compelling argument against the reasonableness of Treasury's determination.[19]

The majority's conclusion was already predetermined when it decided to give an expansive interpretation of *Chevron*. The commissioner had provided a reasoned explanation — that is, congressional mandate and the regulations were upheld as valid.

In contrast, the dissenting opinion immediately focused on the APA and gave it a broad reading: "The foundational principle of administrative law [is] that a court may uphold agency action only on the grounds that the agency invoked when it took the action."[20] A review of the dissenting opinion leads to only one conclusion — if the APA is given a broad reading, the regulation is invalid. First, it was contrary to the literal language of the statute and the regulations are therefore arbitrary and capricious. Second, the regulations were procedurally invalid for two reasons: (1) Treasury failed to address the comments it received, and (2) Treasury never stated that an arm's-length transaction was no longer the governing standard; that is, the commensurate with income standard would solely be the governing standard.

The dissent, citing the amicus brief from Cisco, found that the literal language of the statute (the commensurate with income standard) did not apply to the transaction at issue because there was no intangible that was being transferred. This was consistent with the committee reports of the 1986 amendment, which stated that the standard only applied to transfers of highly valuable intangible property when comparables do not exist.[21] Thus the regulations

[15] *Altera*, 926 F.3d at 1078 (emphasis added).

[16] 5 U.S.C. sections 706 and 553(b). *State Farm*, 463 U.S. at 43, 52.

[17] *Altera*, 926 F.3d at 1081.

[18] *Id.* at 1083.

[19] *Id.* at 1085.

[20] *Id.* at 1087, citing to *Michigan v. EPA*, 135 S. Ct. 2699, 2710 (2015) (citing *SEC v. Chenery Corp.*, 318 U.S. 80, 87 (1943)).

[21] *See Altera*, 926 F.3d at 1090.

could not apply to a matter that was not covered by the statute.[22]

The dissent turned next to the regulations at issue and stressed the notion of parity but noted that parity had always been determined by the prevailing arm's-length standard. In support of its position, it cited *Xilinx*,[23] in which the Ninth Circuit reviewed the 1994 and 1995 regulations[24] and concluded that the IRS had continuously referred[25] to the arm's-length standard as the applicable standard.[26] Regarding the 2003 regulations, the dissent found that Treasury failed during the notice and comment period to state the portions of the legislative history it found pertinent or how any of that history factored into its thinking.[27]

Just as important to the dissent was that the majority departed from a standard on which taxpayers had always relied. Taxpayers assumed that the arm's-length standard was the applicable standard and flooded Treasury with evidence demonstrating that unrelated companies would never share the cost of stock-based compensation. Treasury responded to those comments by pointing out that cost-sharing arrangements were not true comparables because they lacked the characteristics of high-profit intangibles.[28] The dissent was clearly troubled that the majority allowed Treasury to ignore taxpayer comments during the notice and comment phase. The dissent was clear: If the IRS wanted to change the standard, it must follow the APA and give clear notice of the alteration and specific reasons for the change.[29] Thus Treasury's regulations were procedurally invalid, and *Chevron* could not be used to revive them.[30]

Consequently, it can be argued that the commissioner had changed positions — commensurate with income was the applicable standard for this particular "intangible," and more importantly it was a stand-alone standard. The majority makes it clear that the commissioner has the unfettered right to do so under a broad application of *Chevron*.[31]

Unfortunately, the battle between *Chevron* and the APA has financial consequences. As a result of the *Altera* decision, Alphabet Inc., the holding company of Google, had a net tax benefit of $418 million reversed, and Facebook recorded an income tax expense of $1.11 billion.[32]

Conclusion

Consistency was all Altera and the dissent were seeking from the APA.[33] Yet a broad reading of *Chevron* allowed the IRS to ignore consistency and legislate a new standard, applying that standard to a matter that was arguably not even subject to the statute. So much for that axiom we were taught in civics class. ■

[22]For a thorough discussion of the reasoning behind the dissenting opinion, see Amicus Curiae Brief Supporting Appellee and Affirmance on Behalf of Cisco Systems Inc. (Aug. 1, 2019) and Supplemental Brief of Amicus Curiae Cisco Systems Inc. (Oct. 23, 2018).

[23]*Xilinx Inc. v. Commissioner*, 598 F.3d 1191, 1194-1196 (9th Cir. 2010).

[24]Reg. section 1.482-7 was drafted to address the issue of allocating employee stock compensation to a cost-sharing arrangement in controlled transactions.

[25]Reg. section 1.482-1 included the arm's-length standard. A majority of the *Xilinx* court ultimately held that the arm's-length standard, which it described as the fundamental "purpose" of the regulations, trumped reg. section 1.482-7, and that stock-based compensation expenses could not be shared in the absence of evidence that unrelated parties would share such costs. *Xilinx*, 598 F.3d at 1196.

[26]*See Altera* at 1090 citing *Xilinx*, 598 F.3d at 1194-1196.

[27]*Altera*, 926 F.3d at 1093.

[28]*Id.* at 1077-1078.

[29]*Id.* at 1096 (citing *FCC v. Fox Television Stations Inc.*, 556 U.S. 502, 515 (2009)).

[30]*Altera*, 926 F.3d at 1100. Altera filed a petition for rehearing on July 22, 2019.

[31]*See Altera*, 926 F.3d at 1083.

[32]*See* Andrew Velarde, "Tech Giants Give First Glimpse of *Altera*'s Financial Impact," *Tax Notes Federal*, Aug. 5, 2019, p. 920.

[33]Ironically, in *Kisor*, it was the government that begged for consistency and yet when the taxpayers ask for consistency from the same agency it falls on deaf ears. *See Kisor v. Wilkie*, 139 S. Ct. 2400 (2019) ("*Auer* deference imparts 'predictability to the administrative process.' *Auer* deference thus serves to ensure consistency in federal regulatory law, for everyone who needs to know what it requires."). In *Amazon.com Inc. v. Commissioner*, No. 17-72922 (9th Cir. 2019), the Ninth Circuit did cite *Kisor* for the proposition of consistency and held against the government's interpretation of the regulation at issue.