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Focus on Tax Strategies & Developments

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Regulatory Developments Under § 367 Affecting Transfers of Appreciated Property to Foreign Corporations

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INTRODUCTION

On September 14, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released (1) proposed regulations under section 367 of the Internal Revenue Code (the Code) effective (when finalized) retroactively to transfers occurring on or after September 16 (the Proposed Section 367 Regulations), together with (2) temporary regulations under section 482, effective immediately (applicable to tax years ending on or after September 14, 2015) (the Temporary Section 482 Regulations). Among other things, both sets of rules mark dramatic departures from existing guidance regarding cross-border transfers of intangibles. This article focuses on the Proposed Section 367 Regulations.

SUMMARY OF SIGNIFICANT CHANGES FROM PREVIOUS GUIDANCE

The Proposed Section 367 Regulations:

- Eliminate the foreign goodwill and going concern value exception under Treasury regulations section 1.367(d)-1T;
- Limit the scope of property eligible for the active trade or business exception generally to certain tangible property and financial assets;
- Allow taxpayers to apply section 367(d) (rather than 367(a)) to transfers of goodwill and going concern value to foreign corporations;
- Provide that, in cases where an outbound transfer of property subject to section 367(a) constitutes a controlled transaction, the value of the property transferred is to be determined in accordance with the Temporary Section 482 Regulations; and

- Eliminate the 20-year limitation on intangible property transferred under section 367(d).

BACKGROUND

Section 367(a)

Subject to various exceptions, section 367(a) provides that if, in connection with certain corporate non-recognition exchanges (described in sections 332, 351, 354, 356, or 361), a U.S. transferor transfers property to a foreign corporation (an outbound transfer), the transferee foreign corporation "will not be considered to be a corporation" with the effect that the corporate non-recognition rules are rendered inapplicable to the exchange and the U.S. transferor is required to recognize gain on the outbound transfer.

Section 367(a)(3) provides an exception for property transferred to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of the United States (the ATB Exception). However, the ATB Exception does not extend to certain types of property, including copyrights, inventory, accounts receivable, foreign currency and "intangible property" within the meaning of section 936(h)(3)(B), described below (936(h) Intangibles).

Section 367(d)

Section 367(d)(1) provides that, except as provided in regulations, if a U.S. transferor transfers any 936(h) Intangibles to a foreign corporation in an exchange described in sections 351 or 361, the provisions of section 367(d) (and not section 367(a)) apply to the transfer.

In general, under section 367(d), a U.S. transferor that transfers intangible property subject to its provisions is treated as having sold the property in exchange for a series of contingent payments that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of the property (limited to 20 years under the current regulations). The amounts taken into account under section 367(d) must be commensurate with the income attributable to the intangible.

936(h) Intangibles encompass any: (1) patent, invention, formula, process, design, pattern or know-how; (2) copyright, literary, musical or artistic composition; (3) trademark, trade name or brand name; (4) franchise, license or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; and (6) any similar item, in each case, which has substantial value independent of the services of any individual.

Under longstanding Treasury regulations, the provisions of section 367(d) do not apply to foreign goodwill and going concern value—defined as the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued, and including the right to use a corporate name in a foreign country. The regulations are reflective of the sentiments of the legislature at the time of enactment of section 367(d). Congress reasoned that "[g]oodwill and going concern value are generated by earning income, not by incurring deductions [and thus,] ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes."

RATIONALE FOR THE CHANGES

Under the existing regulations, taxpayers have had two different positions available to them under sections 367(a) and (d) in claiming non-recognition treatment for outbound transfers of foreign goodwill and going concern value.

- Goodwill and going concern value *are not* 936(h) Intangibles and therefore are not subject to section 367(d). Further, gain realized with respect to the outbound transfer of goodwill or going concern value is not recognized under the general rule of section 367(a) because the goodwill or going concern value is eligible for the ATB Exception; or
- Even if goodwill and going concern value *are* considered 936(h) Intangibles the foreign goodwill exception applies. Under this scenario, taxpayers can take the position that section 367(a) does not apply to foreign goodwill or going concern value because section 367(d) provides that section 367(d) overrides section 367(a) with respect to 936(h) Intangibles.

The preamble to the Proposed Section 367 Regulations sets forth the rationale of the Treasury and IRS for the changes proposed, stating that "in the context of outbound transfers, certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under section 367." According to the preamble, certain taxpayers seek to minimize the value of property constituting 936(h) Intangibles and to maximize the value of property that may be transferred without triggering current tax, asserting a broad interpretation of the meaning of foreign goodwill and going concern value. In certain cases, the preamble states, taxpayers purport to transfer significant foreign goodwill or going concern value "when a large share of that value was associated with a business operated primarily by employees in the United States . . . where the business simply earned income remotely from foreign customers."

Consequently, despite the belief expressed in the legislative history that the transfer to a foreign corporation of foreign goodwill or going concern value developed by a foreign branch was unlikely to result in abuse of the U.S. tax system, the preamble concludes, the foreign goodwill exception has turned out to be "inconsistent with the policies of section 367 and sound tax administration and [IRS and Treasury] therefore will amend the regulations under section 367 [accordingly]."

DESCRIPTION OF SIGNIFICANT CHANGES

Elimination of ATB Exception for Intangible Property

The Proposed Section 367 Regulations provide an exclusive list of property eligible for the ATB Exception. Under the new approach, property that is not enumerated as "eligible property"—in particular, intangible property—cannot qualify for the ATB Exception regardless of whether the property would otherwise be considered transferred for use in the active conduct of a trade or business outside of the United States. This change is meant to eliminate one of the taxpayer-favorable consequences of a finding that various items (*e.g.*, goodwill) do not constitute 936(h) Intangibles. Thus, even if the item falls outside the scope of section 367(d) and instead is subject to section 367(a), it no longer will be eligible for the ATB Exception to taxability under section 367(a)(1).

Elective Application of Section 367(d)

A U.S. transferor that concludes that goodwill and going concern value are not 936(h) Intangibles may elect to apply section 367(d) to such property. This change is accomplished by revising the definition of "intangible property" to include both property described in section 936(h)(3)(B) and other items in respect of which a U.S. transferor elects to apply section 367(d) (in lieu of applying section 367(a)). Accordingly, under the proposed regulations, upon an outbound transfer of foreign goodwill or going concern value, a U.S. transferor will be subject to either current gain recognition under section 367(a)(1) or the tax treatment provided under section 367(d).

Application of Temporary Section 482 Regulations

In addition, the Proposed Section 367 Regulations provide that, in cases where an outbound transfer of property subject to section 367(a) constitutes a controlled transaction, the value of the property transferred is to be determined in accordance with the Temporary Section 482 Regulations. The Temporary Section 482 Regulations require in general that:

- Compensation for related party transfers must account for all "value provided" (without defining this concept or discussing case law and other authorities to the contrary, such as *Veritas*), regardless of transactional characterization;
- Aggregation principles should be applied to transfers that are economically interrelated and should take into account any value attributable to synergies among the transferred items, even items that are subject to differing tax treatment under the Code and regulations, under the rationale that an aggregate analysis of transactions may provide the most reliable measure of an arm's length result in these circumstances (notwithstanding the Tax Court's conclusion in *Veritas* that the IRS's aggregation approach was actually less reliable than the taxpayer's separate valuations); and
- Determinations of appropriate pricing should take into account realistic alternatives for economically equivalent transactions.

Together these changes are meant to render the characterization of transactions essentially irrelevant to transfer pricing, leaving the IRS more or less free to apply pure (and often questionable) economic theory in making pricing determinations.

In light of the elevation of aggregation principles in the Temporary Section 482 Regulations, the Proposed Section 367 Regulations eliminate the statement in Treasury regulations section 1.367(a)-1T(b)(3)(i) providing that "the gain required to be recognized . . . shall in no event exceed the gain that would have been recognized on a taxable sale of those items of property if sold individually and without offsetting individual losses against individual gains." The Treasury and IRS apparently were concerned that taxpayers may have interpreted the wording "if sold individually" as inconsistent with the use of aggregation principles.

Elimination of 20-Year Useful Life

Finally, the Proposed Section 367 Regulations eliminate the existing rule under Treasury regulations section 1.367(d)-1T(c)(3) that limits the useful life of intangible property to 20 years, on the basis that the limitation can result in less than all of the income attributable to an item of intangible property being taken into account by the U.S. transferor. The Proposed Section 367 Regulations instead provide that the useful life of intangible property is the entire period during which the exploitation of the intangible property is reasonably anticipated to occur, as of the time of transfer. This new rule may prove challenging to comply with and may be overreaching in light of recent cases such as *Veritas* (rejecting an IRS perpetual useful life theory). For example, in certain circumstances this new rule would encompass future research and development activities that expand upon existing intangible property transferred under section 367(d).

CONCLUSION

The Proposed Section 367 Regulations upend longstanding rules such as the foreign goodwill and going concern value exception and the 20-year limitation on the useful life of transferred intangible property. The elimination of the foreign goodwill and going concern value exception seems overly broad in light of the reasons articulated in the preamble to the Proposed Section 367 Regulations. For example, while the preamble offers as a rationale cases where a large share of purported foreign goodwill and going concern value is associated with a business operated primarily by employees in the United States, this rationale is inapposite in cases where the foreign branch in fact conducted most or all of its activities outside the United States. Moreover, the concern expressed in the preamble about taxpayers overstating the value attributable to foreign goodwill and going concern value in order to reduce the value attributed to other assets that may be subject to gain recognition under section 367 should be addressable by the IRS using the tools already at its disposal under section 482 to deal with inappropriate allocations of value. Therefore, outright elimination of the foreign goodwill and going concern value exception seems unnecessary to deal with the identified cases of perceived abuse.

Finally, given the longstanding status of the foreign goodwill and going concern value exception and Congress' express finding that the transfer to a foreign corporation of foreign goodwill or going concern value developed by a foreign branch is unlikely to result in abuse of the U.S. tax system, it is surprising that Treasury and IRS would choose to promulgate a proposed regulation overturning this exception that calls for an immediate effective date.

As dramatic as these developments are, the companion Temporary Section 482 Regulations—presented as "clarifications" notwithstanding *Veritas* and other authorities to the contrary—are also very impactful, given their focus on compensating all "value provided," aggregating economically interrelated transfers (including any value attributable to synergies) and determining pricing based on realistic alternative transactions.

In a broader sense, the Proposed Section 367 Regulations should be viewed in light of Treasury's continuing battle against inversions, regulatory limitations recently imposed on the valuation of transfers to cost-sharing arrangements and the Organization for Economic Co-operation and Development's Base Erosion and Profit Shifting and Business Restructurings initiatives. As Congress has been unable to achieve consensus on corporate tax reform and rate reduction, taxpayers have increased incentives to move business functions abroad, whether through inversion and related planning or through transferring assets and future income streams abroad, where rates are lower and U.S. taxes can be deferred. Meanwhile, the IRS has had limited success contesting taxpayers' valuations for intangible transfers in court as demonstrated by cases such as *Veritas.* The Proposed Section 367 Regulations in conjunction with the Temporary Section 482 Regulations are but the most recent salvo in this ongoing battle over so-called "income shifting". Having failed to implement its policy positions through litigation under the existing law and guidance and through other policy initiatives, the IRS now is amending its core regulations governing outbound transfers. While this is surely a more proper means of effecting Treasury's policy positions than is litigation, the breadth of these regulations and their uneasy footing in the statute and legislative history may leave them open to challenge in some respects (particularly in the wake of the *Altera* case [discussed elsewhere in this newsletter], invalidating part of the cost-sharing regulations based on the IRS's inadequate attempt to defend its regulations as being sufficiently grounded in the law).

Treasury Releases Guidance for Contributions of Appreciated Property to Partnerships with Related Foreign Partners

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On August 6, 2015, 18 years after Congress authorized regulations under section 721(c) of the Internal Revenue Code (Code), the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released Notice 2015-54 announcing that they intend to issue regulations under sections 721(c), 482 and 6662 addressing certain controlled transactions involving U.S. persons that transfer appreciated property to a partnership with foreign related partners. The section 721(c) rules are intended to ensure that the U.S. transferor takes income or gain attributable to the contributed appreciated property into account either immediately or periodically. Treasury and IRS also intend to issue regulations under sections 482 and 6662 to ensure appropriate valuation of such transactions.

OVERVIEW

Notice 2015-54 closes a gap that has existed with respect to outbound transfers of appreciated property to partnerships as compared to outbound transfers of appreciated property to corporations. Under the notice, the general non-recognition rule of section 721(a) will be called off with respect to contributions of built-in gain property (section 721(c) property) by a U.S. transferor to a controlled partnership having foreign related persons as partners (directly or indirectly) unless the partnership applies rules that operate to prevent the U.S. transferor from shifting the built-in gain to related foreign persons.

The rules set forth in Notice 2015-54 are effective for transfers occurring on or after August 6, 2015 (and to transfers occurring *before* that date resulting from entity classification elections filed on or after August 6, 2015).

The notice applies to the transfer of *any* appreciated property by a U.S. person to *any* partnership,existing or newly formed, domestic or foreign, if a related foreign person is a direct or indirect partner in the partnership and the U.S. transferor and one or more related persons (domestic or foreign) own more than 50 percent of the interests in partnership capital, profits, deductions or losses.

BACKGROUND

Prior to their repeal as part of the Taxpayer Relief Act of 1997 (the 1997 Act), sections 1491 through 1494 imposed an excise tax on certain transfers of appreciated property by a U.S. person to a foreign partnership. These rules conceptually corresponded to the section 367 rules governing outbound transfers of appreciated property by a U.S. person to a foreign *corporation*. Section 367 can operate to call off the non-recognition rules of section 351(a) and 368 in connection with such transfers under certain circumstances. Further, in the case of transfers of certain intangible property, section 367(d) can re-characterize a contribution of intangible property to a corporation as a sale in exchange for payments contingent on the productivity, use or disposition of the intangible property, and require the contributor to include annually, over the shorter of the life of the asset or twenty years, an amount reflecting the amounts that would have been received over the life of the asset (or immediately on disposition of the asset). [However, see related article on recently published proposed regulations under section 367.]

Following the repeal of sections 1491 through 1494, contributions of property by a U.S. person to a foreign partnership could be made on a tax-free basis—there was no longer an excise tax and the general non-recognition rules remained in force. Such contributions remained subject to the partnership tax rules applicable generally to contributions of built-in gain (or built-in loss) property ("section 704(c) property"). Mechanically, the section 704(c) rules operate, over time and subject to limitations, to cause the contributing partner to recognize gain (or loss) with respect to the contributed property. Section 704(c) allocations must be made using a reasonable method. However, the consequences of selecting among the available methods are highly fact-dependent; depending on the choices made, the amount and timing of income inclusion will vary; and the use of certain available methods can affect a shift in tax burden as between the contributing partner and the non-contributing partners.

Perhaps recognizing this, as well as the lack of symmetry between the rules applicable to outbound transfers to partnerships and those applicable to outbound transfers to corporate entities, Congress authorized Treasury to promulgate regulations to override the partnership non-recognition rule and to instead impose tax on gain realized on the transfer of property to a partnership (domestic or foreign) if the gain, when recognized, would be includible in the gross income of a person other than a U.S. person. Congress also authorized Treasury to promulgate regulations applying section 367(d) principles to transfers of intangible property to a partnership.

Notice 2015-54 initiates the implementation of this regulatory authority. In addition, the notice further develops the section 482 principles applicable to contributions of property to a partnership.

NOTICE 2015-54

Notice 2015-54 provides that the non-recognition rule generally applicable to contributions of property to partnerships is not applicable in the case of a transfer to a "section 721(c) partnership" *unless* the partnership applies the Gain Deferral Method (described below) with respect to built-in gain property contributed to it by U.S. persons (section 721(c) property).

There are five requirements under the Gain Deferral Method:

- First, the section 721(c) partnership is required to adopt the remedial allocation method for built-in gain with respect to section 721(c) property. The remedial method, which causes the contributing partner to recognize income in the same amount and at the same time as would occur had the contribution not been made, generally operates to eliminate any potential for shifting the tax burden associated with contributed property away from the contributing partner. The use of the remedial method is mandated even in instances where use of an alternative method would not have resulted in any deferral or shift in the burden of taxation.
- Second, as long as there is any remaining built-in gain with respect to section 721(c) property, the section 721(c) partnership is required to allocate all items of section 704(b) income, gain, loss and deduction with respect to the section 721(c) property in the same proportion. It seems clear that the rule was intended to prevent partners from unravelling the impact of remedial allocations through special allocations that might otherwise be respected. That is, to the extent the partnership has section 721(c) property, there will no longer be any ability to "specially" allocate income and loss among the partners with respect to that property. Otherwise, the notice provides little guidance with respect to interpretation of this mandate. For example, it is not clear how this rule would apply to preferred partnership interests when the allocation scheme is designed to protect preferred capital.
- Third, if the section 721(c) partnership is a foreign partnership, a U.S. transferor must comply with the reporting requirements imposed under sections 6038, 6038B, and 6046A. Form 8865 (*Return of U.S. Persons With Respect to Certain Foreign Partnerships*) will be modified to include information with respect to contributions of section 721(c) property to section 721(c) partnerships.
- Fourth, subject to certain exceptions, the U.S. transferor will recognize built-in gain with respect to section 721(c) property on the occurrence of an acceleration event (any transaction that would reduce the amount of remaining built-in gain that the U.S. transferor would recognize, a distribution of the built-in gain property to a person other than the U.S. transferor, or a failure to satisfy the requirements for applying the Gain Deferral Method).
- Fifth, the Gain Deferral Method must be adopted for all section 721(c) property subsequently contributed to the section 721(c) partnership by the U.S. transferor and all other U.S. transferors that are related persons until the earlier of (i) the date that no built-in gain remains with respect to any section 721(c) property to which the Gain Deferral Method first applied or (ii) the date that is 60 months after the date of the initial contribution of section 721(c) property to which the Gain Deferral Method first applied.

Treasury and IRS intend to issue regulations imposing an additional requirement under the Gain Deferral Method that U.S. transferors (and, in certain cases, the section 721(c) partnership) must extend the limitations period with respect to all items related to the contributed built-in gain property through the close of the eighth full taxable year following the year of the contribution. These regulations will not require the limitations-period extension for taxable years that end before the date such regulations are published and will be effective for transfers and controlled transactions occurring on or after the date such regulations are published. The limitations period regulations together with the 60-month rule above appear intended to coordinate the new rules applicable to partnerships with the gain recognition agreement rules applicable to certain outbound transfers to corporate entities.

Notice 2015-54 also addresses Treasury and IRS concerns that partnership interests received in consideration for contributed property may be incorrectly valued, reducing the amount of income or gain allocated to U.S. partners. The IRS has broad authority under section 482 to adjust the allocation of income among parties to a controlled transaction so as to properly reflect the economics of the transaction. The notice states, however, that the IRS faces administrative difficulties when making adjustments years after a controlled transaction has occurred, because taxpayers have better access to information about their businesses and risk profiles than the IRS does.

The Treasury and IRS intend to address this perceived disadvantage by augmenting current cost-sharing regulations under section 482. While the contours of the regulations are not described, the Treasury and IRS intend to provide guidance pertaining to the evaluation of the arm's length amount charged with respect to controlled transactions involving partnerships. The rules are expected to follow Treasury regulations section 1.482-7(g) which provides guidance with respect to the arm's length charge applicable to "platform contributions" (*i.e.,* the buy-in charge for the contribution by a party of a resource, capability or right to the cost-sharing arrangement if it is reasonably anticipated to contribute to the development of the cost-shared intangibles). The "platform contribution" concept is a relatively new one under the cost-sharing regulations and has the effect of widening the scope of the buy-in requirement relative to prior versions of those regulations.

The regulations also will provide that, in the event of a trigger based on a significant divergence of the actual returns from projected returns for controlled transactions involving a partnership, the IRS may make periodic adjustments to the result of such transaction under a method based on Treasury regulations section 1.482-7(i)(6)(v), as appropriately adjusted, as well as any necessary corresponding adjustments to section 704(b) or section 704(c) allocations. These regulations will be effective for transfers and controlled transactions occurring on or after the date of publication of the regulations. The notice points out, however, that adjustments in a current year can be scrutinized on the basis of prior year controlled transactions notwithstanding the fact that the prior year is closed.

The Treasury and IRS also are considering issuing regulations under section 1.6662-6(d) requiring additional documentation for certain controlled transactions involving partnerships. These regulations may require, for example, documentation of projected returns for property contributed to a partnership (as well as attributable to related controlled transactions) and of projected partnership allocations, including projected remedial allocations, for a specified number of years.

CONCLUSION

Notice 2015-54 is a significant development with broad application. The rules apply to any contribution of built-in gain property (whether intangible property or not) to any controlled partnership, new or existing, domestic or foreign, if that partnership has related foreign partners. As a result, the sweep of the notice goes beyond the types of transactions that concerned Treasury and IRS (viz., outbound transfers of appreciated property to partnerships with foreign partners where the gain on the appreciated property can be shifted to the foreign partners). For example, the rules may apply to partnership merger transactions where an "assets over" transaction structure is utilized. In addition, the rules may reach the deemed contribution transactions resulting upon a technical termination of an existing partnership. The notice applies immediately to contributions occurring on or after August 6, 2015 (the date of issuance of the Notice) and even, in certain cases, before August 6, 2015 (if resulting from an entity classification election filed on or after August 6, 2015). Taxpayers therefore should consider carefully the application of these rules whenever structuring a transaction, whether among affiliates or with third parties, involving a partnership with foreign related parties.

Notice 2015-54's extension of recent changes to the regulations governing cost sharing arrangements to partnership transactions is also significant. These recent changes were controversial and extension into the partnership arena will merit attention by affected taxpayers.

Finally, taxpayers should be aware that the notice gives some sense of how the IRS might examine transactions structured well before the notice was released.

Tax Court Decision in *Altera* Overturns Important Transfer Pricing Regulations

Steven P. Hannes

On July 27, 2015, the U.S. Tax Court issued a stunning rebuke to the IRS by invalidating the part of the Internal Revenue Services' (IRS) cost-sharing regulations under section 482 of the Internal Revenue Code that says taxpayers have to take into account, among other costs, the costs of stock-based compensation. The *Altera* decision should also support the many taxpayers who have questioned the separate section 482 regulatory requirement that cost-based transfer pricing (*e.g.*, cost-plus pricing for services) must include the cost of stock-based compensation.

Taxpayers with cost-sharing agreements or other transfer pricing that previously took into account such stock-based compensation costs should consider amending their returns and filing claims for refunds for open years. Taxpayers who followed the approach sustained in *Altera* may want to review their tax provisions.

The opinion, reviewed by the full Tax Court, is important for transfer pricing beyond cost sharing and stock-based compensation costs. The Tax Court held that, as an interpretation of the "arm's length standard," the regulation is invalid because there is no empirical basis for the proposition that third parties share such costs. The opinion concludes that the regulation "lacks a basis in fact."

In other words, according to the full Tax Court, the IRS cannot issue a valid transfer pricing regulation under the arm's length standard that attempts to interpret how related parties "should behave" if there is no empirical evidence that unrelated parties actually behave in that fashion. (In *Altera* there was ample evidence that unrelated parties did not charge each other for the costs of stock-based compensation.) Even though the words "arm's length standard" do not appear in section 482, U.S. courts and the U.S. Treasury Department's comments on treaties (noted in *Altera*) have long said that the statute incorporates this standard, thereby limiting the IRS's ability to reallocate among affiliates.

The IRS argued in Altera that consistency of the cost-sharing regulations with the arm's length standard is not relevant because the cost-sharing regulations are part of an "elective" regulatory regime for cost sharing. The Tax Court dismissed the IRS attempt to recharacterize the relevant provisions as "elective," noting that in the regulatory process the IRS rejected taxpayer suggestions to make the requirement a true safe harbor. (There are other parts of the pricing regulations that taxpayers can truly elect and that *Altera* should not disturb.)

The Tax Court decision may comfort those taxpayers already challenging in court the validity of other provisions of the section 482 regulations that "overreach" (*e.g.*, 3M's pending challenge to the "foreign legal requirements" provision in the regulations).

The holding of the court in *Altera* has relevance to ongoing debates about whether certain Base Erosion and Profit Shifting (BEPS) proposals coming from the Organisation for Economic Co-operation and Development (OECD), such as those asserting that "control" over certain activities is a prerequisite for a related party to claim intangibles profits (or losses), could be adopted administratively in the United States. *Altera* lends support to those who believe the IRS and Treasury could not adopt these proposals as valid regulatory interpretations of the arm's length standard of section 482; instead adoption could only occur through a statutory amendment by Congress.

If the government does not acquiesce in *Altera*, and does not remove the stock-based compensation provisions from the section 482 regulations, then taxpayers will have choices. Those who benefit from including the costs of stock-based compensation in the contexts of cost sharing and transfer pricing, such as a foreign company with significant stock-based compensation costs that provides services or goods to a U.S. affiliate, can continue to rely on the regulations. Those taxpayers who, like Altera, do not benefit from including such costs now have a significant case upon which to rely.

Unfortunately, it would not be surprising if the government appeals *Altera* even though sound tax policy and administrative considerations would argue that it should accept the decision and move on to other issues. However, given the record on this issue, the government will likely have an uphill battle should it appeal.

In conclusion, one might speculate whether *Altera* could mark the beginning of the end of the last 20 years of frequent theory-based (not fact-based) approaches in regulations as to how related parties should behave with respect to their transfer pricing. Even before the issuance of the 1994 regulations, as well as since, the IRS has lost cases in court that were based on theories IRS developed in litigation (essentially all the cases it has litigated). It became apparent to the IRS a few years ago that facts, not theories, convince judges (at least under the current statute) and IRS decided to change its approach to transfer pricing litigation. The IRS has stated that it is focusing on improving its track record in court in part by doing a better job of mastering the facts in litigating a case.

Recently, IRS gave its first response to the question whether *Altera* will cause IRS and Treasury to reexamine and revise the theory-based parts of pricing regulations. As discussed in another article in this edition of our newsletter, on September 14, 2015, IRS issued temporary regulations under 482 (involving transfer pricing issues not at issue in *Altera*) that, unfortunately, indicate that the IRS still is prepared to issue theory-based transfer pricing rules. The preamble to temporary return 482 regulations does not mention *Altera* by name or explain why the IRS believes it appropriate to issue another theory-based pricing regulation not supported by empirical data.

Altera: How to Challenge Tax Regulations on Administrative Law Grounds

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The U.S. Tax Court's opinion in *Altera*, discussed in the preceding article, provides a thorough analysis of how to challenge tax regulations on administrative law grounds.

In *Altera*, the U.S. Tax Court invalidated regulations under section 482 requiring participants in qualified cost-sharing agreements (CSAs) to include stock-based compensation costs in the cost pool to comply with the arm's-length standard. The discussion below summarizes the history of those regulations and focuses primarily on the court's holding and the implications of that holding with respect to administrative law issues.

BACKGROUND

In 2005, the Tax Court held in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), that, under cost-sharing regulations promulgated in 1995, controlled entities entering into CSAs need not share stock-based compensation costs because parties operating at arm's-length would not do so. The Ninth Circuit affirmed, holding that the all costs requirement should be construed as not applying to stock-based compensation because the regulations should be interpreted to accomplish the statutory purpose of grounding the Internal Revenue Service's (IRS) allocation authority in the principle of "parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions," and the U.S. Department of the Treasury (Treasury) technical explanation of the income tax convention between the United States and Ireland confirmed that the commensurate-with-income standard was meant to work consistently with the arm's-length standard.

While the dispute in *Xilinx* was ongoing, but before the Tax Court's opinion was issued, the IRS and Treasury proposed amendments in 2002 to the 1995 cost-sharing regulations purporting to clarify that stock-based compensation must be taken into account in determining operating expenses under Treasury regulations section 1.482-7(d)(1), to provide rules for measuring stock-based compensation costs, and to include express provisions to coordinate the cost sharing rules of

Treasury regulations section 1.482-7 with the arm's-length standard of Treasury regulatiosn section 1.482-1. Several parties submitted written comments to Treasury, and four individuals spoke at a public hearing. Many of the commentators informed Treasury that they knew of no transactions between unrelated parties, including any cost-sharing arrangement, service agreement, or other contract, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation. Additionally, several commentators identified arm's-length agreements in which stock-based compensation was not shared or reimbursed.

Despite the comments, the IRS and Treasury issued final rules in 2003 explicitly requiring parties to CSAs to share stock-based compensation costs. The final rule also added regulations providing that CSAs produce an arm's-length result only if the parties' costs are determined in accordance with the final rule. Treasury's files underlying the final rules did not contain any expert opinions, empirical data, articles, papers or surveys supporting a determination that the amounts attributable to stock-based compensation must be included in the cost pool of CSAs to achieve an arm's-length result. There was also no evidence that Treasury had searched any database that could have contained agreements between unrelated parties relating to joint undertakings or the provision of services, nor that Treasury was aware of any written contract between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation. Nor was there any evidence of any actual transaction between unrelated parties in which one party paid or reimbursed the other party for amounts attributable to stock-based compensation. The preamble responded to certain comments, but did not justify the final rule on the basis of any modification or abandonment of the arm's-length standard. The preamble also concluded that the Administrative Procedure Act (APA) did not apply to the regulations.

ALTERA

In *Altera*, Altera filed a petition with the Tax Court challenging the IRS's allocation of income in accordance with the 2003 cost-sharing regulations. Altera argued that the final rule requiring participants in CSAs to share stock-based compensation costs to achieve an arm's-length result was invalid because it violated the APA. Although similar APA challenges to tax regulations have been raised in the past, (most notably in basis overstatement cases culminating in the Supreme Court's decision in *United States v. Home Concrete & Supply, LLC*, 132 S.Ct. 1836 (2012)), courts had not addressed in detail the specific arguments raised by Altera.

The APA establishes several administrative law requirements for the promulgation of rules and regulations by government agencies. For example, agencies generally must provide the public with notice of, and the opportunity to comment on, proposed regulations that are intended to carry the force of law (*i.e.*, "substantive rules"), and the agency must consider any comments before promulgating final regulations. However, this requirement does not apply to interpretive rules or when the agency determines, and explains in detail, that good cause exists for not providing notice and the opportunity for comment. The APA also requires that a court set aside agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." In *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co*, 463 U.S. 29 (1983), the Supreme Court explained that an agency must have "engaged in reasoned decisionmaking," which means "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.'" Finally, the APA contains a harmless error rule reflecting the notion that if the agency's mistake did not affect the outcome or prejudice the petitioning party, the agency action can be upheld despite the mistake. In *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 57 (2011), the Supreme Court made clear that the APA applies to tax rules and regulations.

In *Altera*, a unanimous Tax Court found that Treasury failed to engage in reasoned decision-making as required under the APA and *State Farm*. Specifically, the court concluded that, in failing to rationally connect the choice it made with the facts, Treasury had engaged in arbitrary and capricious decision-making. Treasury had failed to engage in material fact finding or to follow evidence-gathering procedures and the regulatory record lacked any evidence to support the result set forth in the 2003 regulations. Treasury had failed to respond to significant comments when it issued the 2003 regulations and its conclusion that the 2003 regulations were consistent with the arm's-length standard in fact was contrary to all of the evidence before it. Accordingly, the court ruled that the 2003 regulations were invalid. In doing so, the Tax Court provided a thorough analysis of the application of administrative law principles to Treasury regulations. In particular, the court made the following determinations:

- Treasury regulations issued pursuant to section 7805(a) are legislative regulations because the IRS intends them to "carry the force of law"; thus, Treasury is required to follow the APA's notice and comment requirements absent satisfaction of the good cause exception.
- Tax regulations must be the product of reasoned decision-making; thus, they must have a basis in fact, there must be a rational connection between the facts found and the choice made, significant comments must be responded to, and the final rule may not be contrary to the evidence presented before the final rule is issued.
- The harmless error exception requires at least a reasonable showing by Treasury that it had sufficient alternative reasons for adopting the final rule (at the time the rule was adopted and not in hindsight) in light of its mistake.

PRACTICAL CONSIDERATIONS

A practical question is what is the impact of *Altera*? Obviously, the opinion is a victory for taxpayers disputing the 2003 regulations dealing with stock-based compensation, and affected taxpayers now will have to consider whether to amend their cost-sharing agreements going forward to reflect *Altera*, as well as whether and when "clawback" provisions of existing agreements might be triggered. But the impact of the case and its limits on the IRS's rulemaking authority also could be felt more broadly in the transfer pricing area, as taxpayers may challenge other current (and possibly future) regulation provisions that might not be adequately grounded in the arm's-length standard.

It should be noted, however, that all provisions of the transfer pricing regulations remain binding *on the IRS* regardless of whether such provisions comport with general arm's-length principles. The Tax Court's opinion in *Xilinx*, as well as other Tax Court cases, treats IRS published guidance as concessions by the IRS on an issue given that taxpayers rely on such positions in planning their transactions. For example, taxpayers clearly can continue to rely on provisions like the applicable-federal-rate-based safe harbor for intercompany interest, even though the results of the safe harbor undoubtedly depart from an arm's-length result in many cases. The arm's-length standard that the Tax Court discussed in *Altera* limits the authority of the IRS to issue transfer pricing regulations; the IRS cannot impose regulatory requirements under section 482 that violate that standard.

Even more broadly, the impact of the decision may be felt throughout the tax law, because the decision potentially calls into question the promulgation process for many tax regulations that are currently on the books. Treasury has historically taken the position (incorrectly, as *Altera* demonstrates) that regulations issued pursuant to section 7805(a) are not covered by the APA and many tax regulations lack an extensive discussion of the justification of the rules as envisioned by *State Farm.* Taxpayers challenging regulations may want to review regulatory history to determine whether, under *Altera*, Treasury failed to engage in reasoned decision-making. In this regard, *Altera*, in conjunction with *Dominion Resources, Inc. v. U.S.*, 681 F.3d 1313 (2012), where the U.S. Court of Appeals for the Federal Circuit applied the arbitrary and capricious standard to invalidate Treasury regulations section 1.263A-11(e)(1)(ii)(B) on the ground that Treasury failed to provide an explanation of the reasons behind the regulation, provides an excellent roadmap for undertaking the analysis. Finally, it remains to be seen whether the analysis in *Altera* may strengthen arguments against the IRS's reliance on temporary regulations (particularly those issued before 1989 that have never been finalized) and situations where the IRS applies final regulations retroactively.

It should be noted that Microsoft, which is currently involved in a summons enforcement action with the government in the District Court for the Western District of Washington, recently filed a notice of supplemental authority arguing to that court that *Altera* is relevant to Microsoft's argument that it will make a substantial preliminary showing that enforcing the summonses would be an abuse of the court's process, in part by showing that the IRS violated the APA in promulgating the temporary regulation at issue in that case.

Altera's successful motion for partial summary judgment did not dispose of all issues in the case; thus, the Tax Court has not issued a decision from which the IRS can appeal the case. Once the remaining issues are resolved and a decision is entered, the IRS will need to decide whether to appeal the case (presumably to the Ninth Circuit). It is impossible to predict what the circuit court would decide, but it bears noting that the Ninth Circuit affirmed the

Tax Court's decision in *Xilinx* and the Tax Court in *Altera* cited extensively to Supreme Court and Ninth Circuit precedent (as well as case law from the D.C. Circuit, which hears the majority of administrative law issues) to support its holding that the regulation was invalid.

Altera is a significant case, both in the specific context of transfer pricing and in the general context of the validity of tax regulations. Taxpayers that have followed the 2003 regulations should consider whether to change their transfer pricing practices going forward and whether to file protective refund claims for prior open years. Additionally, as noted above, taxpayers with clawback provisions should consider whether the clawback obligation has been triggered. Taxpayers outside the specific context of the 2003 regulations should also consider the requirements of the APA, including the notice-and-comment procedures, when evaluating whether to take a position that is contrary to a Treasury regulation.

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