Altera Corp. v. Commissioner, 145 T. C. 91 (2015)

In Altera Corp. v. Commissioner, the U. S. Tax Court invalidated a 2003 Treasury regulation requiring companies to include stock-based compensation in cost-sharing agreements, ruling it arbitrary and capricious. This decision, based on lack of evidence and failure to respond to significant public comments, underscores the need for empirical support in regulatory changes affecting corporate tax allocations and highlights the importance of the Administrative Procedure Act's notice-and-comment requirements.

Parties

Altera Corporation and its subsidiaries, the petitioners, challenged the Commissioner of Internal Revenue, the respondent, over deficiencies determined for tax years 2004-2007 based on the application of the 2003 cost-sharing regulations. Altera sought partial summary judgment on the validity of the regulation, while the Commissioner sought to uphold it.

Facts

Altera U. S. , a Delaware corporation, and Altera International, its Cayman Islands subsidiary, entered into a qualified cost-sharing arrangement (QCSA) in 1997. This agreement covered the development and sharing of costs related to programmable logic devices and related software. From 2004 to 2007, Altera U. S. granted stock-based compensation to its employees, but did not include these costs in the cost pool shared with Altera International under the QCSA. The Commissioner, relying on the 2003 Treasury regulation (section 1. 482-7(d)(2), Income Tax Regs.), determined deficiencies by adjusting Altera International's cost-sharing payments to account for the stock-based compensation.

Procedural History

The case was brought before the U. S. Tax Court on cross-motions for partial summary judgment. The court's jurisdiction was based on the petitioners' challenge to the Commissioner's deficiency determination. The Tax Court was to determine the validity of the 2003 Treasury regulation under the Administrative Procedure Act (APA). The court reviewed the regulation without a jury, under the standard applicable to summary judgment motions, assessing whether there were genuine disputes of material fact and whether the regulation was valid as a matter of law.

Issue(s)

Whether the 2003 Treasury regulation (section 1. 482-7(d)(2), Income Tax Regs.), requiring participants in QCSAs to share stock-based compensation costs, is arbitrary and capricious and therefore invalid under the APA?

Rule(s) of Law

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The Administrative Procedure Act requires agencies to engage in notice-and-comment rulemaking for substantive regulations, which must be based on reasoned decision-making and supported by evidence. Under section 482 of the Internal Revenue Code, the Commissioner may allocate income among related entities to ensure tax parity with uncontrolled taxpayers, adhering to the arm's-length standard. This standard requires that transactions between related parties reflect what would occur between unrelated parties under comparable circumstances.

Holding

The 2003 Treasury regulation requiring the inclusion of stock-based compensation in QCSAs was held to be arbitrary and capricious and thus invalid under the APA. The court found that the regulation lacked a basis in fact, failed to rationally connect the choice made with the facts found, did not adequately respond to significant public comments, and was contrary to the evidence before Treasury.

Reasoning

The court's reasoning encompassed several critical points:

– **Lack of Empirical Evidence:** Treasury failed to provide any evidence supporting the belief that unrelated parties would share stock-based compensation costs in QCSAs. The court highlighted that Treasury did not conduct any fact-finding or empirical research, relying solely on its belief without substantiation.

– **Failure to Address Public Comments:** Treasury did not adequately respond to significant comments submitted during the notice-and-comment period. Commentators provided evidence that unrelated parties do not share stock-based compensation, yet Treasury dismissed this evidence without thorough analysis or justification.

– **Rational Connection to Facts:** The regulation treated all QCSAs uniformly without distinguishing between those involving high-profit intangibles where stock-based compensation was significant and those where it was not. This lack of differentiation failed to provide a rational connection between the regulation's broad application and the specific facts it purported to address.

– **Contrary to Evidence:** The court noted that the regulation's premise was contradicted by all evidence before Treasury, including surveys, economic analyses, and examples of arm's-length agreements that did not include stock-based compensation.

– **Administrative Procedure Act:** The court determined that the regulation was subject to the APA's notice-and-comment requirements because it was a legislative rule with the force of law. Treasury's failure to comply with these requirements, particularly in responding to comments, was a significant factor in the court's decision.

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– **Harmless Error Rule:** The court rejected the application of the harmless error rule, finding that it was not clear Treasury would have adopted the regulation if it had concluded that the rule conflicted with the arm's-length standard.

Disposition

The court granted Altera's motion for partial summary judgment, invalidating the 2003 Treasury regulation. The Commissioner's motion was denied, and the court instructed that an appropriate order be issued to reflect this decision.

Significance/Impact

The Altera decision is significant for several reasons:

– It reinforces the requirement for empirical support and reasoned decision-making in regulatory changes, particularly in the context of tax regulations affecting multinational corporations.

– The ruling underscores the importance of the APA's notice-and-comment process, emphasizing that agencies must respond meaningfully to significant public comments.

– It impacts the treatment of stock-based compensation in cost-sharing arrangements, potentially affecting how multinational companies structure their agreements and report income.

– The decision may influence future regulatory actions by Treasury and other agencies, highlighting the need for thorough justification and evidence in rulemaking.

– It may lead to further litigation or regulatory changes as companies and the IRS navigate the implications of the court's decision on existing and future cost-sharing agreements.

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