Nos. 16-70496, 16-70497

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ALTERA CORPORATION AND SUBSIDIARIES,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISIONS OF
THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

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TABLE OF CONTENTS

Page

Table of contents i
Table of authorities iii
Glossary vi
Introduction 1
Argument 6

A. The coordinating amendments are based on a permissible construction of § 482 6

1. Treasury's interpretation of § 482 gives proper effect to the commensurate-with-income requirement 6

2. Treasury's interpretation of § 482 is not barred by the rule disfavoring statutory amendments by implication 11

3. The 1986 legislative history strongly supports Treasury's interpretation of § 482 16

4. Treasury's interpretation of § 482 does not conflict with treaties 20

B. The arguments in our opening brief in support of the substantive validity of the coordinating amendments are not barred by *Chenery* 22

C. Treasury's interpretation of § 482, as reflected in the coordinating amendments, did not represent an unacknowledged change in agency policy 30

D. Xilinx's argument that this Court's decision in *Xilinx* precludes the Court from upholding the validity of the coordinating amendments in this case is meritless 39

Page

E. Treasury's determination that stock-based compensation expense is a "cost" easily satisfies the reasoned-decisionmaking standard 40

Conclusion 45
Certificate of service... 46
Certificate of compliance (Form 8) .... *post*

TABLE OF AUTHORITIES

Cases: **Page(s)**

Blanchette v. Conn. Gen. Ins. Corps.,
419 U.S. 102 (1974) 12
Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.,
467 U.S. 837 (1984) 2, 22-24
Ciba-Geigy Corp. v. Commissioner,
85 T.C. 172 (1985) 8
Commissioner v. Ewing,
439 F.3d 1009 (9th Cir. 2006) 19
E. I. Du Pont de Nemours & Co. v. United States,
608 F.2d 445 (Ct. Cl. 1979) 8
Eli Lilly & Co. v. Commissioner,
84 T.C. 996 (1985), *aff'd in part, rev'd in part*,
856 F.2d 855 (7th Cir. 1988) 8
Exxon Mobil Corp. v. Allapattah Servs., Inc.,
545 U.S. 546 (2005) 16
Maracich v. Spears,
133 S. Ct. 2191 (2013) 13
Michigan v. E.P.A.,
135 S. Ct. 2699 (2015) 41
Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.,
463 U.S. 29 (1983) 2-3, 5, 29, 42
Nat'l Elec. Mfrs. Ass'n v. U.S. Dept. of Energy,
654 F.3d 496 (4th Cir. 2011) 24, 26
Nat'l R.R. Passenger Corp. v. Boston & Maine Corp.,
503 U.S. 407 (1992) 26
SEC v. Chenery Corp.,
318 U.S. 80 (1943) 22-24, 26, 42
United States v. Dahl,
314 F.3d 976 (9th Cir. 2002) 12-13
United States v. Stuart,
489 U.S. 353 (1989) 20

Cases (cont'd): **Page(s)**

United States v. Welden,
377 U.S. 95 (1964) 12
Xilinx Inc. v. Commissioner,
125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191
(9th Cir. 2010) 17, 33
Xilinx Inc. v. Commissioner,
567 F.3d 482 (9th Cir. 2009), *withdrawn*,
592 F.3d 1017 (9th Cir. 2010) 17, 40, 42
Xilinx Inc. v. Commissioner,
598 F.3d 1191 (9th Cir. 2010) 17, 20

Statutes:

Internal Revenue Code (26 U.S.C):

§ 83(h) 43
§ 162 43
§ 162(a) 43
§ 367(d) 18
§ 482 .... 2-3, 5-9, 11, 14-22, 25, 28, 30, 33-34, 36, 39
§ 7805(a) 18

Tax Reform Act of 1986, Pub. L. No. 99-514,
§ 1231(e)(2), 100 Stat. 2085, 2563 (1986) 18

Regulations:

Treasury Regulations (26 C.F.R.):

§ 1.482-1 .... 1, 31
§ 1.482-1(a)(1) 6
§ 1.482-1(b)(1) 1, 6, 27, 34-36
§ 1.482-1(b)(2)(i) (2003) 1
§ 1.482-2(d)(2)(iii) (1968) 9
§ 1.482-2(d)(4) (1968) 31
§ 1.482-4(f)(2) 11, 35

Regulations (cont'd): **Page(s)**

Treasury Regulations (26 C.F.R.):

§ 1.482-7 .... 1, 31
§ 1.482-7(a)(1) (1995).................... 17
§ 1.482-7(a)(2) (1995).................... 32
§ 1.482-7(a)(3) (1995).................... 17
§ 1.482-7(a)(3) (2003).................... 2, 25
§ 1.482-7(d)(1) (1995) 32
§ 1.482-7(d)(2) (2003) 1, 41

Miscellaneous:

Compensatory Stock Options Under Section 482,
67 Fed. Reg. 48,997 (July 29, 2002) 28, 30-31, 41

H.R. Conf. Rep. No. 99-841 (1986) 5, 9, 16, 19-20, 25, 28, 32, 36

H.R. Rep. No. 99-426 (1985).................... 10, 13, 16, 35-36

Notice 88-123, 1988-2 C.B. 458.................... 15, 33-34

T.D. 8552, 1994-2 C.B. 93 36

T.D. 9088, 2003-2 C.B. 841 .... 25-26, 28-30, 36, 43

GLOSSARY

Br. – Altera's answering brief

Cisco Br. – Amicus Curiae brief filed by Cisco Systems, Inc.

ER – Excerpts of Record

ESO – employee stock option

Gov't Br. – Commissioner's opening brief

QCSA – qualified cost-sharing arrangement

SBC – stock-based compensation

Xilinx Br. – Amicus Curiae brief filed by Xilinx, Inc.

INTRODUCTION

At issue in this case is the substantive and procedural validity of the 2003 amendments to Treas. Reg. §§ 1.482-1 and 1.482-7 (the "2003 cost-sharing amendments"), which govern cost-sharing arrangements entered into by commonly controlled entities for the purpose of developing intangible property. One of those amendments clarified that the existing definition of development-related "costs" that a cost-sharing arrangement must encompass in order to be treated as a qualified cost-sharing arrangement (QCSA) – a definition that clearly encompassed compensation expense – includes the cost of stock-based compensation (SBC) such as stock options. *See* Treas. Reg. § 1.482-7(d)(2) (2003) (the "SBC rule"). Other amendments clarified that the existing rule requiring QCSA participants to share all development-related costs in proportion to their reasonably anticipated benefits from the arrangement must be satisfied in order for the QCSA to produce an "arm's-length result" within the meaning of Treas. Reg. § 1.482-1(b)(1), *i.e.*, the result one would expect to see if unrelated parties dealing at arm's length had engaged in the same transaction under the same circumstances. *See* Treas. Reg. §§ 1.482-1(b)(2)(i) (2003) (second

sentence), 1.482-7(a)(3) (2003) (the "coordinating amendments"). The SBC rule and the coordinating amendments reflected positions the IRS had taken in both prior and then-ongoing litigation.

The substantive validity of the 2003 cost-sharing amendments turns on whether they are "based on a permissible construction of" I.R.C. § 482. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984). Their procedural validity turns on whether Treasury "articulate[d] a satisfactory explanation for its action," thereby enabling a reviewing court to conclude that such action "was the product of reasoned decisionmaking." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43, 52 (1983).

As explained in our opening brief (Gov't Br. 33-38, 43-47), the Tax Court erroneously framed the *State Farm* issue in terms of whether Treasury had any empirical basis – *e.g.*, evidence of transactions between unrelated parties – for concluding that a rule requiring QCSA participants to share stock-based compensation costs is consistent with the arm's-length standard that delimits the IRS's authority under § 482 to reallocate tax items between related entities. In providing that a QCSA will achieve an arm's-length result only if *all* development-

related costs – without qualification – are shared in proportion to anticipated development-related benefits, Treasury necessarily dispensed with empirical inquiries regarding whether unrelated parties share particular costs under allegedly comparable arrangements. The Tax Court's failure to consider the validity of *that* action, *i.e.*, the validity of the coordinating amendments, invalidates its entire *State Farm* analysis.

We demonstrated in our opening brief (Gov't Br. 48-57) that the coordinating amendments are based on a permissible construction of § 482. In particular, Treasury's authority to define an arm's-length result in this context based on adherence to a bedrock economic principle derives from the commensurate-with-income requirement added to § 482 in 1986. That statutory language requires that the income with respect to any transfer or license of intangible property be commensurate with the income attributable to the intangible. Read in conjunction with the arm's-length standard implicit in the first sentence of § 482, the 1986 amendment effectively provides that a transfer or license of intangible property between commonly controlled entities will satisfy the arm's-length standard – *i.e.*, its results will be consistent

with the results one would expect to see if unrelated parties had engaged in the same transaction under the same circumstances – only if the income to the transferor or licensor is commensurate with the income that the transferee or licensee derives from the intangible property. The coordinating amendments in the 2003 regulations – consistent with legislative history expressly addressing the implementation of the commensurate-with-income requirement in the context of cost-sharing arrangements – similarly provide that a QCSA will satisfy the arm's-length standard *only* if the participants share all costs of intangible development in proportion to their reasonably anticipated benefits from the arrangement (the "cost-share/benefit principle").

We also showed (Gov't Br. 57-66) that the preambles accompanying the issuance of the 2003 cost-sharing amendments in proposed and final form (the "2002 preamble" and the "2003 preamble," respectively) demonstrate that the coordinating amendments were the product of reasoned decisionmaking. Those preambles emphasize Treasury's view that requiring QCSAs to incorporate the cost-share/ benefit principle as a condition to achieving an arm's-length result

implements congressional intent as reflected in the Conference Report accompanying the 1986 legislation. *See* H.R. Conf. Rep. No. 99-841, at II-638 (1986) (the "1986 Conference Report"). The committee report provides a rational basis for Treasury's conclusion in that regard, which is all that *State Farm* requires here.

Before turning to the specific arguments raised in Altera's answering brief, we note the overarching infirmity of Altera's substantive position in this case. Altera does not suggest that the cost-share/benefit principle – which ensures the proper matching of income and expenses as between related participants in a cost-sharing arrangement – represents an improper departure from the statutory commensurate-with-income requirement. *See* H.R. Conf. Rep. No. 99-841, at II-638. Nor does Altera assert that the income of QCSA participants would be "clear[ly]…reflect[ed]" within the meaning of § 482 if there were a mismatch of such income and expenses. Finally, Altera does not dispute that such a mismatch will occur if a cost relating to the development activity is excluded from the pool of costs to be shared (unless the participants happen to incur the omitted cost in the exact same amounts). Yet, Altera insists that the arm's-length

standard requires that result. Altera's position that the arm's-length standard gives related taxpayers carte blanche to mismatch their income and expenses by means of a cost-sharing arrangement wherein a significant cost item, *i.e.*, stock-based compensation, is not shared cannot be squared with the statutory commensurate-with-income requirement and the legislative intent behind its enactment.

ARGUMENT

A. The coordinating amendments are based on a permissible construction of § 482

1. Treasury's interpretation of § 482 gives proper effect to the commensurate-with-income requirement

Altera contends (Br. 56) that the coordinating amendments are substantively invalid because "Section 482 cannot reasonably be interpreted to permit the Commissioner to disregard the arm's-length standard and the parity principle."[1] That argument simply begs the

[1] Achieving "tax parity" – *i.e.*, parity in the measurement of taxable income, as between related taxpayers transacting with one another and unrelated taxpayers transacting with one another – is the goal of the arm's-length standard. *See* Treas. Reg. §§ 1.482-1(a)(1) (stating that tax parity is achieved by determining the true taxable income of the controlled taxpayer), 1.482-1(b)(1) (stating that the true taxable income of a controlled taxpayer is determined under the arm's-length standard).

question as to the meaning of the arm's-length standard that the parties agree is implicit in the first sentence of § 482. As explained in our opening brief (Gov't Br. 48-57), the arm's-length standard – which is based on comparability analysis where reliably comparable uncontrolled transactions exist – cannot be understood in the context of transactions involving intangible property without considering the commensurate-with-income requirement added to § 482 in 1986 and the legislative history of that amendment. The statutory commensurate-with-income requirement – which unqualifiedly requires an internal comparison of the two sides of the related-party transaction, rather than a comparison of the related-party transaction to comparable transactions between unrelated parties – can be reconciled with the arm's-length standard only if it is understood to have established a rule to the effect that a transfer or license of intangible property between unrelated parties will not be deemed comparable to a related-party transaction for these purposes unless it yields a price for the related-party transaction that satisfies the commensurate-with-income requirement. *See* Gov't Br. 54.

That there are situations where no reliably comparable uncontrolled transactions exist to guide the arm's-length inquiry under § 482 – particularly in the context of transactions involving intangible property – was not a novel proposition in 1986. *See Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172, 226 (1985) (holding that "the record does not contain a sufficiently similar transaction involving an unrelated party"); *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1150 (1985) (holding that "[t]he three preferred pricing methods detailed in the regulations are clearly inapplicable due to a lack of comparable or similar uncontrolled transactions"), *aff'd on this point,* 856 F.2d 855, 869-870 (7th Cir. 1988); *E. I. Du Pont de Nemours & Co. v. United States*, 608 F.2d 445, 454 (Ct. Cl. 1979) (holding that "taxpayer has not shown that…any of its alleged comparables can be accepted as such," and noting that "it may very well be that, because of [the foreign subsidiary's] unique position," such a showing "could simply not be made"). In those situations, compliance with the arm's-length standard was necessarily determined by reference to assumptions regarding rational economic behavior, rather than by reference to observed behavior (*i.e.*, actual transactions between unrelated parties).

Where the 1986 legislation broke new ground was in adopting an assumption regarding rational economic behavior – *viz*., that unrelated parties would "divi[de] [the] income" attributable to the intangible in a manner that "reasonably reflect[s] the relative economic activity undertaken by each," H.R. Conf. Rep. No. 99-841, at II-637 – that applies at the outset in the form of a rule of law of universal application to transactions involving intangible property. In other words, the commensurate-with-income requirement is not a default rule that applies only when the parties to a § 482 dispute are unable to establish the existence of a sufficiently comparable uncontrolled transaction from which an arm's-length result may be inferred. *Cf*. Treas. Reg. § 1.482-2(d)(2)(iii) (1968) (former regulation providing a list of factors that "may be considered in arriving at the amount of the arm's length consideration" for the transfer or use of intangible property "[w]here a sufficiently similar transaction involving an unrelated party cannot be found"). Rather, the commensurate-with-income requirement *starts* from the premise that the comparability of uncontrolled transactions in this context is sufficiently problematic to require preemptive reliance on an economic assumption regarding how unrelated parties would price

the related-party transaction under scrutiny. *See* H.R. Rep. No. 99-426, at 424 (1985) (the "1986 House Report") (expressing concern that courts too often made unwarranted findings of comparability, particularly "where transfers of intangibles are concerned"); *id*. at 425 (citing the "extreme difficulties in determining whether the arm's length transfers [of intangibles] between unrelated parties are comparable" to the related-party transaction).

As further explained in our opening brief (Gov't Br. 53-54), the 1986 House Report contemplated that the commensurate-with-income requirement would encompass periodic adjustments to royalty payments to reflect actual profit experience. Nothing in that report suggests that periodic adjustments would *not* be appropriate if a taxpayer could establish that unrelated parties do not provide for such periodic adjustments in their agreements. Nor does Altera take issue with the authorities we cited stating that such periodic adjustments are indeed "not consistent with third party commercial dealings" and "rare between independent parties." *See id*. at 54-55. Yet, in 1988 Congress legislatively confirmed that the commensurate-with-income requirement is consistent with U.S. tax treaties (all of which

incorporate the arm's-length standard). *See* Gov't Br. 11-12. Altera's proffered explication of the arm's-length standard – pursuant to which related parties could render the periodic-adjustment rule (implemented in 1994 in Treas. Reg. § 1.482-4(f)(2)) inapplicable by pointing to evidence that unrelated parties do not provide for such adjustments in their agreements – is therefore contrary to congressional intent. In contrast, Treasury's application of the arm's-length standard, as reflected in the coordinating amendments, is consistent with Congress's intent in enacting the commensurate-with-income requirement and thus is based on a permissible construction of § 482.[2]

2. Treasury's interpretation of § 482 is not barred by the rule disfavoring statutory amendments by implication

Altera contends (Br. 62-63) that the 1986 amendment of § 482 had no practical effect on the then-existing version of § 482 – which consisted of a single sentence – because the amendment took the form of a second sentence, "without touching the pertinent language" of the

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[2] Notably, Altera's argument (Br. 58-62) that Treasury's understanding of the arm's-length standard conflicts with the purpose of § 482 makes no mention of the commensurate-with-income requirement.

first sentence. According to Altera, any suggestion that the enactment of the second sentence had an effect on the manner in which Congress intended the arm's-length standard (implicit in the first sentence) to operate would violate the canon of statutory construction that disfavors amendments by implication. As the cases cited by Altera illustrate, however, that canon applies where a later-enacted statutory provision allegedly conflicts with an existing, *separate* statutory provision. *See Blanchette v. Conn. Gen. Ins. Corps.*, 419 U.S. 102, 133-134 (1974) (holding that the Regional Rail Reorganization Act of 1973 would not be construed as narrowing the longstanding Tucker Act grant of jurisdiction over claims against the United States founded upon the Constitution); *United States v. Dahl*, 314 F.3d 976, 978 (9th Cir. 2002) (holding that 1996 legislation did not impliedly amend the separate, existing provisions of 16 U.S.C. § 460l-6a).[3] The canon does not apply where, as here, the subsequent enactment is an amendment to the very

[3] In the other case cited by Altera, *United States v. Welden*, 377 U.S. 95 (1964), the subsequently enacted statute expressly clarified (by cross-reference) the language of a separate, previously enacted statute. The amendment-by-implication issue pertained to the subsequent legislation's silence on another issue.

statutory provision in issue. Indeed, such a rule would run counter to the principle that "an interpretation of a phrase of uncertain reach is not confined to a single sentence when the text of the whole statute gives instruction as to its meaning." *Maracich v. Spears*, 133 S. Ct. 2191, 2203 (2013).

But even if the canon disfavoring amendment by implication were potentially applicable here, it would be overridden by Congress's "clear and manifest" intent, *Dahl*, 314 F.3d at 978, to impose a preemptive check on comparability analysis in the context of transactions involving intangible property. Contrary to Altera's claim (Br. 63), Congress was hardly "silent[ ]" in that regard. As indicated in our opening brief (Gov't Br. 52-53), the 1986 House Report speaks at length to the Ways and Means Committee's frustration with "the inconsistent results of attempting to impose an arm's length concept in the absence of comparables," particularly "where transfers of intangibles are concerned." H.R. Rep. No. 99-426, at 424. To argue that Congress did not intend the commensurate-with-income requirement to have any effect on the manner in which the arm's-length standard is to be applied in this area is to ignore the entire impetus for amending the statute.

Indeed, under Altera's position, Congress's amendment of § 482 to add the commensurate-with-income requirement – spurred by the conviction that the comparability analysis being applied by the courts to discern an arm's-length result in transactions involving intangible property was inherently defective – would be largely rendered a nullity.

Although Altera insists (Br. 63-64) that the commensurate-with-income requirement is entirely consistent with its concept of an arm's-length standard that relies exclusively on comparability analysis, it fails to explain how that is so. According to Altera (*id*. at 64), the only consequence of the commensurate-with-income requirement is that it "allow[s] the Commissioner to make periodic adjustments to…parity-based pricing" (*i.e*., prices derived from comparability analysis) in order to reflect actual profit experience. *See* pp. 10-11, *supra*. Altera fails to explain, however, how that authorization could be consistent with its concept of the arm's-length standard in light of the authorities cited in our opening brief stating that such periodic adjustments themselves are "not consistent with third party commercial dealings" and "rare between independent parties." *See* Gov't Br. 54-55. Indeed, if the arm's-length standard required exclusive reliance on comparability

analysis, then periodic adjustments to "parity-based pricing" would violate the arm's-length standard, since the determination of the parity-based price would be the end of the matter.

Altera's failure to grasp the interaction between the commensurate-with-income requirement and the arm's-length standard is made clear in its attempt to garner support from Notice 88-123, 1988-2 C.B. 458 (the "White Paper"). Contrary to Altera's assertion, the statement in the White Paper that "intangible income must be allocated on the basis of comparable transactions if comparables exist," *id*. at 474, does *not* support its position (Br. 64) that "actual unrelated party transactions are always relevant under section 482." Actual unrelated-party transactions are relevant under § 482 – *i.e.*, for purposes of determining the arm's-length result through comparability analysis – only if they are sufficiently comparable to the related-party transaction at issue. And the commensurate-with-income requirement necessarily established as a rule of law that an unrelated-party transaction involving the transfer or license of intangible property will not be deemed comparable to a related-party transaction of that nature unless

it yields a price for the related-party transaction that satisfies the commensurate-with-income requirement.

3. The 1986 legislative history strongly supports Treasury's interpretation of § 482

If, as Altera asserts (Br. 65), analyzing legislative history is "'an exercise in looking over a crowd and picking out your friends,'" then Altera's citation (*id*. at 68) to one sentence of the 1986 House Report in response to our analysis confirms that it has very few friends in this crowd.[4] Altera does not seriously suggest that the 1986 House Report supports its position that Congress did not intend the commensurate-with-income requirement to have any effect on the manner in which the arm's-length result is determined in the context of related-party transfers and licenses of intangible property. Rather, it contends that the 1986 Conference Report – in which the conferees indicated that they "d[id] not intend to preclude the use of" cost-sharing arrangements "if and to the extent such agreements are consistent with the purposes of this provision," H.R. Conf. Rep. No. 99-841, at II-638 – is irrelevant

[4] We note that in the case cited by Altera here, Justice Kennedy recognized that "Members of this Court have disagreed" with his generally negative view of legislative history. *Exxon Mobil Corp. v. Allapattah Servs., Inc.*, 545 U.S. 546, 569 (2005).

because (according to Altera) the language of the statute precludes Treasury from implementing the commensurate-with-income requirement in the context of cost-sharing arrangements (which, according to Altera, do not involve a "transfer" of intangible property within the meaning of § 482).[5]

Altera's statutory preclusion argument – which this Court did not address in either of its *Xilinx* opinions, despite its having been briefed – lacks merit. Nothing in § 482 precludes a broad interpretation of the word "transfer" that would include the relinquishment of future exploitation rights pursuant to a cost-sharing arrangement. *See Xilinx Inc. v. Commissioner*, 125 T.C. 37, 52 (2005) (recognizing that "[f]or purposes of section 482, this relinquishment [of "exclusive ownership of all exploitation rights"] constitutes a transfer of specified future exploitation rights"), *aff'd*, 598 F.3d 1191 (9th Cir. 2010); Treas. Reg. § 1.482-7(a)(1) (1995) (referring to "the interests in the intangibles assigned to [the participants] under the arrangement"); Treas. Reg. § 1.482-7(a)(3) (1995) (referring to "transfers of intangibles other than

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[5] Altera made no such argument in the Tax Court. Thus, the Tax Court had no occasion to address it.

in consideration for bearing a share of the costs of the intangible's development").[6] In any event, nothing in § 482 requires an interpretation of the commensurate-with-income language as prohibiting Treasury from extending its application – assuming, *arguendo*, that it does not already apply by its terms – to cost-sharing arrangements, *i.e.*, pursuant to the Secretary's statutory mandate to "prescribe all needful rules and regulations for the enforcement of this title." I.R.C. § 7805(a). Indeed, Treasury's broad discretion under § 482 suggests the opposite.

In favoring a narrow interpretation of the word "transfer" in § 482, as well as a narrow interpretation of the commensurate-with-income requirement in general, Altera has provided no reason why Congress would regard that requirement as being appropriate only in the case of

[6] One amicus supporting Altera points to a comment by the staff of the Joint Committee on Taxation in the 1984 "Blue Book." Cisco Br. 6. The brief mistakenly states (*id.*) that the comment pertained to "a 1984 precursor to [the commensurate-with-income requirement]." The legislation referenced by the amicus – the 1984 amendment of I.R.C. § 367(d) (a gain-recognition provision) – did not impose the commensurate-with-income requirement or any precursor thereto; that requirement was added to § 367(d) at the same time it was added to § 482, *i.e.*, in 1986. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(2), 100 Stat. 2085, 2563 (1986).

transactions involving a formal transfer or license of intangible property and not in the case of a cost-sharing arrangement for the development of such property. Nor could it, as the legislative history of the commensurate-with-income requirement demonstrates that Congress never intended to draw a distinction between these "method[s] of allocating income attributable to intangibles among related parties." H.R. Conf. Rep. No. 99-841, at II-638. In that regard, it is entirely appropriate to consult the relevant legislative history to determine congressional intent, since the text of § 482 is susceptible to more than one reasonable interpretation on this matter. *See, e.g., Commissioner v. Ewing*, 439 F.3d 1009, 1013 (9th Cir. 2006).

The 1986 Conference Report disposes of Altera's "transfer" argument by clearly expressing the expectation that the IRS would issue regulations applying the commensurate-with-income requirement to cost-sharing arrangements. *See* H.R. Conf. Rep. No. 99-841, at II-638. And, that report goes much further, not only conditioning the continued use of such arrangements on adherence to "the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each," but also

identifying the cost-share/benefit principle as the means for achieving that purpose. *Id.*; *see also* Gov't Br. 55-57. In short, in amending the regulations to expressly require that cost-sharing arrangements for the development of intangible property adhere to the cost-share/benefit principle (and, by extension, the commensurate-with-income requirement) in order to achieve an arm's-length result, Treasury did exactly what Congress intended it to do. Notably, Altera does not even *mention* the 1986 Conference Report in making its (untenable) "transfer" argument.

4. Treasury's interpretation of § 482 does not conflict with treaties

Altera's assertion that Treasury's interpretation of the commensurate-with-income requirement (as reflected in the coordinating amendments) is "belied by United States tax treaties" that "b[i]nd [the U.S.] to the arm's-length standard," Br. 69, is itself belied by Altera's own reasoning. After citing Treasury's Technical Explanation of a 1989 treaty, Altera states (*id*. at 70):

> "Although not conclusive, the meaning attributed to treaty provisions by the Government agencies charged with their negotiation and enforcement is entitled to great weight." *United States v. Stuart*, 489 U.S. 353, 369 (1989); *accord Xilinx*, 598 F.3d at 1198 n.1 (Fisher, J., concurring).

We note that in the period following the issuance of the coordinating amendments in August 2003 to the present, the United States has entered into income tax treaties with eight countries: Bangladesh, Belgium, Bulgaria, Hungary, Iceland, Japan, Malta, and Poland.[7] Consistent with the U.S. Model Treaty, each of those treaties incorporates the arm's-length principle in Article 9, paragraph 1. And, each of the accompanying Technical Explanations, in a paragraph confirming that the commensurate-with-income standard "was designed to operate consistently with the arm's-length standard," states that "[t]he implementation of this standard *in the section 482 regulations* is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines." [Emphasis added.][8] By Altera's own admission (Br. 70), those statements are entitled to "'great weight.'"

[7] The treaties with Hungary and Poland have yet to be ratified.

[8] The treaties and the accompanying Technical Explanations are available at Treasury's website, www.treasury.gov.

B. The arguments in our opening brief in support of the substantive validity of the coordinating amendments are not barred by *Chenery*

In arguing that our *Chevron* analysis of the coordinating amendments – *i.e.*, our explanation why those amendments reflect a permissible construction of § 482 – is barred by *SEC v. Chenery Corp*., 318 U.S. 80 (1943), Altera fundamentally misconstrues the purpose of *Chenery* and its applicability to this case. *Chenery* involved judicial review of an order of the Securities and Exchange Commission approving a public utility holding company's plan of reorganization. The Commission, exercising its statutory authority to ensure that the plan was "fair and equitable," approved the plan except in regard to preferred shares acquired by the company's officers and directors while the plan was under review. The opinion accompanying the order, however, revealed that the Commission had not based its decision on its independent judgment of what was "fair and equitable," but on an erroneous understanding of "principles of equity derived from judicial decisions," which did *not* support the decision. *Id*. at 88. Although appellate counsel offered the Court reasons why the order could nonetheless be sustained as a proper exercise of the Commission's

statutory discretion, the Court demurred, noting that "the considerations urged here in support of the Commission's order were not those upon which its action was based." *Id.* at 92. The Court therefore directed that the case be remanded so that the *Commission* could appropriately justify its order in the first instance.

There is no similar disconnect here. Treasury justified the coordinating amendments on the ground that they implemented legislative intent, *i.e.*, that they reflected how Congress, in enacting the commensurate-with-income requirement in 1986, intended the arm's-length standard to operate in the context of cost-sharing arrangements. *See* Gov't Br. 57-66. In our opening brief, we did not purport to offer additional grounds on which the validity of those amendments may be upheld; rather, we explained *why* Treasury was justified in concluding that the amendments were consistent with legislative intent. *See id.* at 48-57. *Chenery* does not preclude an administrative agency, in defending its action in a judicial proceeding, from providing legal arguments in support of the previously stated ground for its action, including arguments pertaining to *Chevron* analysis. As the Fourth Circuit aptly observed:

> We will not hold against the DOE the more sophisticated legal arguments it sets forth in its submissions to this Court. … Most assuredly,…[*Chenery*] does not oblige the agency to provide exhaustive, contemporaneous legal arguments to preemptively defend its action. Similarly, when (and if) its action is challenged, the DOE is not hamstrung to limit its legal arguments to the four corners of the administrative record. In promulgating the Final Rule, the DOE set forth a coherent interpretation of the statutory definition and gave a sufficient explanation thereof. And in response to NEMA's challenge, it was not only expected but also a duty that the DOE would further explain and elucidate its interpretation and how it fits within the *Chevron* framework. Neither of these actions undermine the weight given to DOE's interpretation.

Nat'l Elec. Mfrs. Ass'n v. U.S. Dept. of Energy, 654 F.3d 496, 515 (4th Cir. 2011).

Altera's failure to grasp the distinction between additional grounds (prohibited by *Chenery*) and the development of previously stated grounds (not prohibited by *Chenery*) is best illustrated by its observation (Br. 44) that "[n]owhere [in the preambles] did the Secretary contend…that the commensurate-with-income provision changed the arm's-length standard into a 'term of art.'" Altera is referring to a passage from our opening brief (Gov't Br. 69) where we argued that, in enacting the commensurate-with-income requirement,

> Congress necessarily viewed the descriptor 'arm's-length' as a term of art, since it contemplated that adherence to the

> arm's-length principle implicit in § 482 could be premised on economic assumptions regarding how unrelated parties would price the same transaction under the same circumstances…, rather than by reference to observed transactions between unrelated parties.

But that is not a new ground for upholding the validity of the coordinating amendments; rather, it is a corollary of Treasury's stated position that Congress intended that cost-sharing arrangements would be deemed to be "consistent with the commensurate with income standard, and therefore consistent with the arm's length standard," only if they incorporated the cost-share/benefit principle. T.D. 9088, 2003-2 C.B. 841, 842.

Altera's assertion (Br. 43) that "[n]owhere in the regulatory history did the Secretary suggest that he 'was statutorily authorized to dispense with comparability analysis'" in the context of QCSAs is puzzling. Treas. Reg. § 1.482-7(a)(3) (2003), which provides that a QCSA produces an arm's-length result if, and only if, it incorporates the cost-share/benefit principle, necessarily presupposes an interpretation of § 482 as permitting Treasury to dispense with comparability analysis in this context. And Treasury clearly expressed not only its belief (based on the 1986 Conference Report) that the coordinating

amendments implemented legislative intent, but also its disagreement with the proposition that the arm's-length result could not be determined without reference to evidence of unrelated-party behavior. *See* T.D. 9088, 2003-2 C.B. at 842; *see also* Gov't Br. 63-64. *Chenery* simply does not require the degree of specificity sought by Altera. *See Nat'l R.R. Passenger Corp. v. Boston & Maine Corp.*, 503 U.S. 407, 419-420 (1992) (acknowledging the rule of *Chenery*, but holding that "the fact that the ICC did not in so many words articulate its [proffered] interpretation of the word 'required' [in the opinion it issued] does not mean that we may not defer to that interpretation, since the only reasonable reading of the [ICC's] opinion…is that the ICC's decision was based on the proffered interpretation"); *Nat'l Elec. Mfrs.*, 654 F.3d at 513 (likewise acknowledging *Chenery*, but citing *Boston & Maine* for the proposition that "deference is appropriate…when the agency's litigation papers merely set forth an interpretation that was a 'necessary presupposition' of its underlying action").

Altera erroneously asserts (Br. 43-44) that statements in the preambles expressing fealty to the arm's-length standard are inconsistent with our argument that Treasury understood that it was

statutorily authorized to dispense with comparability analysis in this context and intended to do so in issuing the 2003 amendments. Comparability analysis is the generally applicable – but not exclusive – means of determining the arm's-length result, *i.e.*, the expected result if unrelated entities had engaged in the same transaction under the same circumstances. *See* Treas. Reg. § 1.482-1(b)(1) (stating that "whether a [related-party] transaction produces an arm's length result *generally* will be determined by reference to the results of comparable [unrelated-party] transactions under comparable circumstances") (emphasis added). Altera makes a similar mistake when it complains that "[n]owhere did the Secretary contend that the commensurate-with-income provision was an *exception* to the arm's-length standard." Br. 44 (emphasis in original). The reason Treasury did not make that argument in the preambles – and the reason we did not (despite Altera's suggestion to the contrary) make it in our opening brief – is that there *are* no exceptions to the arm's-length standard; it applies "in every case." Treas. Reg. § 1.482-1(b)(1) (first sentence). Rather, Treasury's position (both in the preambles and in this appeal) is that the commensurate-with-income requirement is entirely consistent with

the arm's-length standard; to the extent it represents an exception to anything, it is an exception to the generally applicable means of *determining* the arm's-length result, *i.e*., comparability analysis.

Altera's final "nowhere" argument – that Treasury "nowhere indicated [in the preamble] that [its] 'belief' about what unrelated parties would do was superseded by a 'purely internal' statutory standard" (Br. 45) – makes no sense. Treasury's conclusion regarding the expected result if unrelated parties entered into a QCSA was *based* on the statutory commensurate-with-income requirement, not *superseded* by it, and we never suggested otherwise in our opening brief. More precisely, Treasury's conclusion was based on the economic assumption adopted by Congress in enacting the commensurate-with-income requirement, *viz*., that unrelated parties would "divi[de] [the] income" attributable to the intangible in a manner that "reasonably reflect[s] the relative economic activity undertaken by each." H.R. Conf. Rep. No. 99-841, at II-637; *see* T.D. 9088, 2003-2 C.B. at 842 (discussing this aspect of the 1986 Conference Report); *Compensatory Stock Options Under Section 482*, 67 Fed. Reg. 48,997, 48,998 (July 29, 2002) (same).

To be sure, as we acknowledged in our opening brief (Gov't Br. 64), the 2003 preamble contains certain extraneous language that would have benefited from some clarification. In particular, after justifying the coordinating amendments' preemption of comparability analysis as implementing legislative intent, Treasury then expressed the view that the "uncontrolled transactions cited by commentators" were not sufficiently comparable to a QCSA in any event. T.D. 9088, 2003-2 C.B. at 842. Treasury's observation that the cited examples were inapposite, however, hardly obscured the overriding message of the preambles, *viz.*, that Treasury was implementing legislative intent in conditioning arm's-length status for QCSAs on adherence to the cost-share/benefit principle, with no exceptions based on comparability analysis. Because that message reasonably may be discerned from the preambles (notwithstanding the extraneous language in the 2003 preamble), Altera's contention that Treasury violated *State Farm*'s "reasoned decisionmaking" standard must fail. As explained in our opening brief (Gov't Br. 65-66), the degree of clarity of Treasury's reasoning was more than sufficient to pass muster under *State Farm*.

C. Treasury's interpretation of § 482, as reflected in the coordinating amendments, did not represent an unacknowledged change in agency policy

In arguing that the interpretation of § 482 underlying the coordinating amendments represented an unacknowledged change in agency policy, Altera misstates the policy by once again conflating comparability analysis and the arm's-length standard. According to Altera (Br. 47), the "new" policy ushered in by the coordinating amendments is that "the commensurate-with-income clause [of § 482] supplants the arm's-length standard." But the 2003 preamble expressly refers to cost-sharing arrangements that are "consistent with the commensurate with income standard, *and therefore consistent with the arm's length standard*." T.D. 9088, 2003-2 C.B. at 842 (emphasis added); *see also* 67 Fed. Reg. at 48,998 (noting in the 2002 preamble that "Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm's length standard"). Altera may disagree with Treasury's determination that its application of the commensurate-with-income requirement to cost-sharing arrangements was consistent with the arm's-length standard, but it cannot seriously claim that, in issuing the coordinating

amendments, Treasury took the position that the commensurate-with-income requirement supplants the arm's-length standard (or that we took that position in our opening brief).

In any event, the history leading up to the issuance of the 2003 cost-sharing amendments belies Altera's claim of an unannounced policy change. The coordinating amendments were intended to "clarify the coordination of the cost sharing rules of § 1.482-7" – the 1995 regulation that "implement[ed] the commensurate with income standard in the context of cost sharing arrangements" – "with the arm's length standard as set forth in § 1.482-1." 67 Fed. Reg. at 48,998. The 1968 cost-sharing regulation had provided that the IRS would "not make allocations with respect to" a bona fide cost sharing arrangement "except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property," as determined by reference to comparable uncontrolled transactions. Treas. Reg. § 1.482-2(d)(4) (1968). In contrast, the 1995 regulation – which generally became effective January 1, 1996 – provided that the IRS would "not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled

participant's share of the costs (as determined under paragraph (d) of this section) of intangible development…equal to its share of reasonably anticipated benefits attributable to such development." Treas. Reg. § 1.482-7(a)(2) (1995). Thus, the 1995 regulation effectively tied the concept of the "arm's length share" under the 1968 regulation – which *had* been tied to comparable uncontrolled transactions – to the cost-share/benefit principle set forth in the 1986 Conference Report. *See* H.R. Conf. Rep. No. 99-841, at II-638. And, consistent with the unqualified reference in the 1986 Conference Report to "all research and development costs," *id*., the 1995 regulation defined a participant's "costs" for these purposes as "all of the costs incurred by that participant related to the intangible development area." Treas. Reg. § 1.482-7(d)(1) (1995).

In the *Xilinx* litigation (which resulted from an audit that included Xilinx's 1996-1998 tax years and culminated in December 2000), the IRS took the position that the "all costs" requirement of the 1995 regulation was not subject to comparability analysis, *i.e.*, that a taxpayer could not justify the exclusion of certain relevant costs from its cost-sharing pool based on evidence that unrelated parties would not

share such costs. In that regard, the IRS argued that "'application of the express terms of [the 1995 regulation] itself produces an arm's-length result.'" *Xilinx*, 125 T.C. at 54. Altera's argument that the 2003 coordinating amendments – which served only to clarify (*i.e.*, codify) the IRS's existing position on this point – represented an unannounced change in agency policy is therefore baseless. *See* Xilinx Br. 17 (correctly arguing as amicus in support of Altera that "the IRS itself did not view the 2003 regulation as a change").

Altera nonetheless claims (Br. 49) that, prior to the issuance of the coordinating amendments, Treasury and the IRS "repeatedly recognized that the addition of the commensurate-with-income provision to Section 482 did not permit the Commissioner to disregard arm's-length evidence," *i.e.*, evidence of how unrelated parties behave (or claim they would behave) in the context of allegedly comparable transactions involving intangible property.[9] None of Altera's arguments in support of that claim has any merit.

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[9] Altera also claims that "Treasury and the IRS repeatedly have declared that 'intangible income must be allocated on the basis of comparable transactions if comparables exist.'" Br. 49 (quoting Notice 88-123, 1988-2 C.B. 458, 474). But the immediately preceding sentence (continued…)

First, Altera notes (Br. 49) that when Treasury overhauled the § 482 regulations in 1994, it retained the longstanding rule providing that the arm's-length standard applies "in every case." Treas. Reg. § 1.482-1(b)(1) (first sentence). That is correct, but does not equate to a recognition on Treasury's part that *comparability analysis* applies in every case in determining the mandated arm's-length result. Altera then erroneously states that the next sentence of § 1.482-1(b)(1), originating in 1994, "defines 'arm's length' in terms of *real-world analysis*, *looking to uncontrolled transactions involving* 'the same transaction under the same circumstances (arm's length result).'" Br. 49-50 (emphasis added). Here's what the sentence actually says: "A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized if* uncontrolled taxpayers *had* engaged in the same transaction under the same circumstances (arm's length result)." Treas. Reg.

(…continued)
in Notice 88-123 refers to "normal profit intangibles *in which comparables normally exist*." 1988-2 C.B. at 474 (emphasis added). Moreover, the separate chapter of Notice 88-123 dealing with "Cost Sharing After the Tax Reform Act of 1986" does not contain the word "compare" or any derivative thereof. *See id*. at 495-500.

§ 1.482-1(b)(1) (second sentence) (emphasis added). Section 1.482-1(b)(1) thus does not seek to conform the results of the controlled transaction to the results of a nonexistent "real-world" transaction that is identical in all respects to the controlled transaction; rather, it posits what the results of the actual controlled transaction would have been if unrelated parties had stepped into the shoes of the related transacting parties. Although that hypothetical exercise is generally informed by the results of "comparable transactions under comparable circumstances," *id.* (third sentence), that is not always the case.[10]

Second, Altera notes (Br. 51) that "the transfer pricing methods provided in the regulations were (and still are) profoundly factual in nature." No surprise there, given that the arm's-length result is "generally…determined by reference to the results of comparable transactions under comparable circumstances." Treas. Reg. § 1.482-

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[10] Citing Treas. Reg. § 1.482-4(f)(2), which implemented (in 1994) the periodic-adjustment rule contemplated in the 1986 House Report, *see supra* pp. 10-11, 14-15, Altera erroneously asserts (Br. 50) that the regulation "made clear" that Treasury's authority under the commensurate-with-income requirement was limited to making periodic adjustments to royalty payments. Moreover, that Treasury provided limited relief from the periodic-adjustment rule (*see id.* at 50 n.14) does not mean that it was statutorily *required* to do so. *See* Gov't Br. 51.

1(b)(1) (third sentence); *see also* T.D. 9088, 2003-2 C.B. at 842 (acknowledging that "the results actually realized in similar transactions under similar circumstances *ordinarily* provide significant evidence in determining whether a controlled transaction meets the arm's length standard") (emphasis added). But the general prevalence of comparability analysis in the § 482 regulations in the years leading up to 2003 does not equate to a recognition on Treasury's part that it could never depart from comparability analysis in implementing the commensurate-with-income requirement. Indeed, the 1994 regulation implementing the periodic-adjustment rule contemplated in the 1986 House Report did just that. *See* pp. 10-11, 14-15, *supra*.[11] And, as indicated above, the 1995 cost-sharing regulation dropped the reference to comparability that appeared in the 1968 cost-sharing regulation. Those changes, like the 2003 coordinating amendments, are entirely consistent with the view expressed in the 1986 House Report that

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[11] Notably, the preamble to the 1994 regulations harmonizes the arm's-length standard with the stated purpose of the commensurate-with-income requirement. *See* T.D. 8552, 1994-2 C.B. 93, 98 (stating that the allocation of income between transacting related parties under the arm's-length standard should reflect the relative economic activity undertaken by each); H.R. Conf. Rep. No. 99-841, at II-637 (1986).

judicial reliance on purportedly comparable transactions involving intangible property left much to be desired.[12]

Third, Altera notes (Br. 52) that, in the wake of the 1986 legislation, Treasury "t[old] our treaty partners that the commensurate-with-income provision was not intended to override the arm's-length standard." As indicated above, however, Treasury did not purport to override the arm's-length standard when it issued the coordinating amendments; rather, it stated that it was clarifying its position under the 1995 cost-sharing regulation that adherence to the cost-share/benefit principle produces an arm's-length result (*i.e.*, that the arm's-length result in this context is determined by reference to an economic assumption rather than by reference to allegedly comparable uncontrolled transactions). Treasury's prior statements to our treaty

[12] Altera's observation (Br. 51) that, "[e]ven where they provided general rules, the regulations uniformly allowed taxpayers to show that a different result should apply based on evidence of [unrelated-party] behavior," does not help its case. First, the examples cited by Altera do not pertain to transactions involving intangible property. Second, the commensurate-with-income requirement contains no "escape hatch" that would allow taxpayers to show that a different result should apply based on evidence of unrelated-party behavior. *See* Gov't Br. 54 n.15.

partners regarding the primacy of the arm's-length standard are fully consistent with Treasury's subsequent actions up to the present day.

Altera's fourth point (Br. 53) is equally infirm: "In reports to Congress in 1988 and 1992 and in public statements by agency officials, the Secretary and the Commissioner articulated Treasury's clear position that the commensurate-with-income standard did not depart from, let alone contravene, the arm's-length standard." Again, Altera cannot establish a change in agency policy by reference to its *perception* of agency policy. As we have demonstrated herein and in our opening brief, in clarifying that the cost-share/benefit principle, rather than comparability analysis, is dispositive of the arm's-length result in the narrow context of cost-sharing arrangements, Treasury did not depart from, or abandon, the arm's-length standard. Rather, consistent with the commensurate-with-income requirement and the intent of Congress, Treasury prescribed a different means of ascertaining the arm's-length result, *i.e.*, on the theory that cost-sharing arrangements between unrelated parties for the development of intangible property are not sufficiently comparable to QCSAs to provide a reliable arm's-length result. The preambles clearly convey Treasury's view that the

coordinating amendments are fully consistent with both the arm's-length standard and the commensurate-with-income requirement.

Altera's fifth point, that "the Commissioner continues to insist in other cases being litigated *right now* that Section 482 requires the Commissioner to put related parties on tax parity with unrelated parties," Br. 53 (emphasis in original), is repetitive of its third and fourth points, since "tax parity" is simply the goal of the arm's-length standard. *See* note 1, *supra*. By preventing domestic companies from manipulating the terms of cost-sharing arrangements with foreign subsidiaries in order to shift taxable income overseas, the coordinating amendments place such companies on a tax parity with domestic companies that do not have foreign subsidiaries.

D. Xilinx's argument that this Court's decision in *Xilinx* precludes the Court from upholding the validity of the coordinating amendments in this case is meritless

In its amicus brief, Xilinx erroneously asserts that the coordinating amendments "do[ ] not change the applicability of the decision of the Ninth Circuit in *Xilinx* or its rationale." Xilinx Br. 17. According to Xilinx, "[t]he regulation statements that the IRS result is arm's length does not change the initial *Xilinx* majority's conclusion: 'If

unrelated parties operating at arm's length would not share the ESO cost, requiring controlled parties to share it is simply not an arm's length result.'" *Id.* at 18 (quoting *Xilinx Inc. v. Commissioner*, 567 F.3d 482, 491 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010)). Xilinx, however, fails to mention the accompanying footnote:

> [T]he Secretary has since modified the regulations to state explicitly that ESOs are costs that must be shared and that the all costs requirement is an arm's length result, despite the absence of any evidence that unrelated parties share ESOs. *Congress and regulators may adopt a technical definition of a term that is distinct from its plain meaning*, but we are concerned here only with the regulations in effect in 1997, 1998, and 1999, *which did not explicitly define an "arm's length" result to require sharing of ESOs*.

Id. at 491 n.9 (citations omitted; emphasis added). Although the Court clearly considered the term "arm's-length" to have had a plain meaning that foreclosed the Government's position in *Xilinx*, *cf*. Gov't Br. 69-72, it just as clearly recognized that Treasury could rectify the situation by amending its regulations (as Treasury did here).

E. Treasury's determination that stock-based compensation expense is a "cost" easily satisfies the reasoned-decisionmaking standard

Contrary to Altera's assertion (Br. 75), the issue whether corporations incur a "cost" associated with the issuance of stock-based compensation is not a fact question that can be "answered empirically."

Because our federal income tax system is concerned with measuring results from operations, it necessarily relies on accounting-based information. And from an accounting perspective, stock-based compensation expense is a cost. As Treasury explained in the 2002 preamble, then-existing "tax and other accounting principles" recognized that there is a "cost associated with stock-based compensation." 67 Fed. Reg. at 48,999; *see* Gov't Br. 14-15 & n.6, 67-68.[13] That is an entirely "logical and rational" basis, *Michigan v. E.P.A.*, 135 S. Ct. 2699, 2706 (2015), for Treasury's decision to specify in the SBC rule (Treas. Reg. § 1.482-7(d)(2) (2003)) that the term "operating expenses" includes stock-based compensation expense.[14]

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[13] Along those lines, the Tax Court did not, as Altera contends (Br. 73), "f[ind] [that] the rulemaking record contradicted the Secretary's conclusion that stock-based compensation constitutes a cost." Rather, the Tax Court faulted Treasury for not directly rebutting the opinion of two economists that there is no *economic* cost associated with the issuance of stock-based compensation. Because both tax accounting and financial accounting principles recognized that there is an *accounting* cost associated with the issuance of stock-based compensation, the economists' opinion is of marginal relevance. *See* note 14, *infra*.

[14] As Xilinx acknowledges in its amicus brief, "[a]ll three of the Ninth Circuit judges [in *Xilinx*] determined that stock options were included under the 1995 cost sharing regulation," *i.e.*, that the pre-2003 definition of "costs" in the cost-sharing regulation encompassed stock-

(continued…)

Altera's arguments on this issue merit only a brief response. First, Altera suggests (Br. 74) that our argument regarding the non-empirical nature of the "cost" issue is somehow barred by *Chenery* because Treasury did not specify in the 2003 preamble that the cost issue was not empirical. But our argument in that regard is not a new ground for upholding the validity of the SBC rule; rather, it simply conveys that the reasonableness (*i.e.*, under *State Farm*) of Treasury's decision to designate stock-based compensation expense as a cost is not dependent on the weighing of "evidence." Altera likewise suggests (Br. 74) that the reasonableness of Treasury's decision cannot be upheld on the basis of financial accounting principles, since (according to the Tax Court) Treasury "expressly disavowed reliance" on such principles in the 2003 preamble. (ER76.) But the Tax Court was clearly mistaken in

(…continued)
based compensation expense. Xilinx Br. 16; *see Xilinx Inc. v. Commissioner*, 567 F.3d 482, 493-495 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010); *see also* 567 F.3d at 500 (Noonan, J., dissenting) (implicitly adopting the majority's conclusion in this regard). If the Commissioner correctly interpreted the word "cost" in the 1995 regulation as including stock-based compensation expense, it is difficult to imagine how Treasury's codification of that interpretation in the SBC rule lacked a "reasoned basis," as Altera claims (Br. 75).

that regard; Treasury merely agreed with comments, made in response to the discussion of financial accounting principles in the 2002 preamble, that "the disposition of financial reporting issues does not *mandate* a particular result under these regulations." T.D. 9088, 2003-2 C.B. at 843 (emphasis added); *see* Gov't Br. 68.

Finally, Altera erroneously reasons (Br. 74-75) that, since stock-based compensation does not always give rise to a tax deduction, the fact that it generally does give rise to a tax deduction does not support the conclusion that it gives rise to a cost. Altera fails to recognize that, under the generally applicable rule, stock-based compensation is deductible under § 162 as a trade or business *expense* (cost). *See* I.R.C. §§ 83(h), 162(a). That general rule supports the notion that stock-based compensation is a cost, and the fact that a cost is not always deductible (for various reasons; *e.g.*, capital expenditures are not deductible but must be added to basis) does not make it any less of a cost. Altera then seems to suggest (Br. 75) that, even if the general deductibility of stock-based compensation does support the conclusion that stock-based compensation gives rise to a cost, Treasury disavowed any reliance on that rationale – previously expressed in the 2002 preamble – by issuing

a rule that treats both deductible and nondeductible stock-based compensation as costs. To repeat, Treasury took the position that the general deductibility of stock-based compensation supports the conclusion that stock-based compensation is a cost, *period* – not just when it is deductible. That the SBC rule treats both deductible and nondeductible stock-based compensation as costs is not merely consistent with that position; it necessarily follows therefrom.

CONCLUSION

The decisions of the Tax Court are erroneous and should be reversed.

Respectfully submitted,

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NOVEMBER 2016

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