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NOBODY'S STOCK COMPARES TO YOUR OWN: HOW TREASURY CAN REVIVE STOCK COMPENSATION IN COST-SHARING AGREEMENTS

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ABSTRACT—In *Altera Corp. v. Commissioner*, the United States Tax Court invalidated a 2003 Treasury Regulation for failing to meet *State Farm*'s reasoned decisionmaking standard under the Administrative Procedure Act (APA). Invalidating this specific regulation eliminates one of the federal government's latest attempts to limit income tax avoidance by some of the world's largest and wealthiest corporations in the murky world of transfer pricing. This Note demonstrates that the Tax Court's ruling must be limited to its specific APA holding and argues that Treasury may enact a similar regulation under the existing statutory and regulatory framework of the arm's length standard.

Under the APA, Treasury must respond to all significant comments and provide a reasonable statement of basis and purpose for a new regulation. This Note offers viable responses to the public comments Treasury (apparently) inadequately addressed and proposes a framework for a statement of basis and purpose that would satisfy *State Farm*'s reasoned decisionmaking standard under the APA. These responses demonstrate that sharing employee compensation expenses indexed to a corporation's stock price is not comparable between related and unrelated parties because they have inherently different risks. Therefore, while Treasury failed to respond to comments that provided evidence that unrelated parties do not share stock-based compensation, a finding that determined the outcome in *Altera*, it does not follow that requiring unrelated parties to share stock-based compensation violates the overarching arm's length standard. Finally, this Note proposes that if Treasury can provide evidence that related companies share a smaller percentage of *total* employee compensation relative to unrelated companies in similar arrangements, such a regulation is consistent with the arm's length standard. This regulation would be consistent with the standard because it creates transaction results that are "consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the

same transaction," and achieves the purpose of Internal Revenue Code § 482.

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> *It has become common for managers to tell their owners to ignore certain expense items that are all too real. "Stock based compensation" is the most egregious example. The very name says it all: "compensation." If compensation isn't an expense, what is it?*
>
> —Warren Buffett[†]

INTRODUCTION

Politicians frequently announce an intent to close corporate tax loopholes.[1] Presidential candidate Hillary Clinton made preventing "inversions," "where businesses move their corporate residence abroad on paper in order to escape paying their fair share of taxes," a bulwark of her campaign's tax policy.[2] However, even if this goal was achieved, another form of multinational corporate tax avoidance endures—transfer pricing manipulation. When multinational companies manipulate transfer pricing, they do not seek to move their corporate residence abroad, but rather, they seek to move their corporate profits abroad in order to escape paying their fair share of taxes. As a conservative estimate, economists believe that inappropriate transfer pricing practices allow the United States' largest corporations to avoid over $100 billion annually in tax expense.[3] To put that number into perspective, U.S. corporations only paid $317 billion in taxes in 2014, so almost one-third of all corporate tax collected is lost every year due to inappropriate transfer pricing methods.[4] Understandably, tax scholars believe "transfer pricing has become, and remains, the single most important international taxation issue for both tax administrations and taxpayers."[5]

Treasury recently failed in its bid to address one particular transfer pricing issue in *Altera Corp. v. Commissioner*.[6] Treasury's loss raises

[†] Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders, Berkshire Hathaway Inc., at 16 (Feb. 27, 2016), http://www.berkshirehathaway.com/letters/2015ltr.pdf [https://perma.cc/A5JP-TK3D].

[1] *Ending Inversions and Investing in America*, HILLARYCLINTON.COM, https://www.hillaryclinton.com/briefing/factsheets/2015/12/08/ending-inversions-and-investing-in-america/ [https://perma.cc/YKU5-SPWX].

[2] *Id.*

[3] STAFF OF S. SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REP. ON DIVIDEND TAX ABUSE: HOW OFFSHORE ENTITIES DODGE TAXES ON U.S. STOCK DIVIDENDS 1 (Comm. Print 2008), http://www.hsgac.senate.gov//imo/media/doc/091108DividendTaxAbuse.pdf [https://perma.cc/2H26-R3FA].

[4] INTERNAL REVENUE SERV., 2014 DATA BOOK, PUBLICATION 55B, at 3 (2014), https://www.irs.gov/pub/irs-soi/14databk.pdf [https://perma.cc/JLG6-TK78].

[5] CYM H. LOWELL & PETER L. BRIGER, U.S. INTERNATIONAL TRANSFER PRICING ¶ 1.08, Westlaw 476826 (database updated 2016).

[6] The government has subsequently filed for appeal to the Ninth Circuit. Notice of Appeal, Altera Corp. v. Comm'r, No. 16-70497 (9th Cir. Feb. 19, 2016). Although the outcome could possibly change

significant practical issues for the U.S. government by creating a huge gap in its ability to tax some of the most profitable U.S.-based companies. In *Altera*, the U.S. Tax Court[7] invalidated a 2003 Treasury regulation on Administrative Procedure Act (APA) grounds for failing to meet *State Farm*'s reasoned decisionmaking standard.[8] The Tax Court's decision marked the U.S. government's third consecutive failed attempt to require foreign subsidiaries engaged in a subset of transfer pricing called "cost-sharing agreements" to reimburse their U.S. parent companies (and thus make those U.S. companies subject to tax on reimbursement) for U.S. stock-based compensation expenses.[9] Just as Warren Buffet is baffled by corporate managers' attempts to convince shareholders that stock-based compensation is not an expense,[10] Treasury has been baffled by taxpayers' attempts to convince courts that stock-based compensation is not an expense companies must share in these agreements.

Overall, *Altera*'s reversal significantly reduces the United States' ability to tax companies that devote significant resources to research and development (R&D), which include very profitable and very large high-tech, medical device, and pharmaceutical companies. This is particularly impactful because the development of new technology by companies that devote significant resources to R&D is one of the United States' most

upon appeal, this is unlikely because the Tax Court's decision was without dissent. Furthermore, the substance of this Note stands irrespective of a potential reversal.

7 The Tax Court is a court of record established by Congress under Article I of the U.S. Constitution, and is composed of nineteen presidentially appointed members. *About the Court*, UNITED STATES TAX COURT, https://www.ustaxourt.gov/about.htm [https://perma.cc/7VUX-4ZQA]. After "the Commissioner of Internal Revenue has determined a tax deficiency, the taxpayer may dispute the deficiency in the Tax Court before paying any disputed amount." *Id*. Taxpayers may appeal a Tax Court decision to the federal circuit court where the taxpayer resides "in the same manner and to the same extent as decisions of the federal district courts in civil actions tried without a jury." BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 115.6, Westlaw 440105 (database updated 2016).

8 Altera Corp. v. Comm'r, 145 T.C. 91, 92 (2015), *appeal docketed*, No. 16-70497 (9th Cir. Feb. 23, 2016). The Tax Court decision was unanimous because all voting judges signed on to the opinion. *Id.* at 134.

9 Ajay Gupta, *News Analysis:* Altera*—Third Time's Not a Charm*, WORLDWIDE TAX DAILY (Aug. 3, 2015), LEXIS 2015 WTD 148-1 (citing Treasury's previous two failed attempts to require companies participating in cost-sharing agreements to share stock-based compensation expense). In *Seagate Technology, Inc. v. Commissioner*, T.C. Memo 200-388 (2000), the IRS conceded the issue after the taxpayer motion survived summary judgement. *Id.* In *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), as will be discussed in Section II.E, the taxpayer succeeded based on language of 1995 regulations addressing this issue. *See infra* Section II.E.

10 Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders, Berkshire Hathaway Inc., at 16 (Feb. 27, 2016), http://www.berkshirehathaway.com/letters/2015ltr.pdf [https://perma.cc/A5JP-TK3D] ("[I]t has become common for managers to tell their owners to ignore certain expense items that are all too real. 'Stock-based compensation' is the most egregious example. The very name says it all: 'compensation.' If compensation isn't an expense, what is it?").

important remaining comparative advantages in the global market,[11] and thus a valuable source of present and future U.S. tax revenue. The type of cost-sharing agreements at issue allowed a foreign subsidiary to reimburse a U.S. parent company for its R&D costs, in return for an ownership right in the assets developed.[12] The reimbursement from the foreign subsidiary is taxable income in the United States, and the invalidated regulation required stock-based compensation to be one of the costs included in the reimbursement calculation. The high-tech industry covets cost-sharing agreements, calling them "an indispensable tool for managing global intangible property rights."[13] And in a perfect storm, they similarly covet the use of stock-based compensation, stating it helps attract and retain qualified workers, and thus is a "key engine of growth and innovation in the U.S. economy."[14] The frequent use of the two practices by the high-tech industry means that the invalidated regulation will significantly reduce the U.S. government's ability to tax these companies. For instance, about 20% of Apple Inc.'s $8 billion in R&D expenses from 2015 came from stock-based compensation.[15] Similarly, stock-based compensation made up almost 22% percent of Google's $12 billion 2015 R&D expense.[16] Because of this invalidated regulation, Google alone realized a $3.5 billion tax benefit now that its subsidiaries in these agreements no longer have to reimburse for stock-based compensation.[17]

Before diving deeper into *Altera*'s cost-sharing agreement and stock-based compensation focus, it may be helpful to describe briefly the general concept of transfer pricing for those unfamiliar. First, the largest companies in the United States are not individual entities. Rather, each "company" is

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[11] Frank A. Wolak, *Our Comparative Advantage*, N.Y. TIMES (Jan. 19, 2011), http://www.nytimes.com/roomfordebate/2011/01/18/can-the-us-compete-with-china-on-green-tech/our-comparative-advantage [https://perma.cc/C8FD-2RLH] (stating the United States has an advantage in the production of goods that are human- and physical-capital intensive because of its relative abundance of highly educated labor force and technologically sophisticated equipment).

[12] *See infra* note 39.

[13] Caroline Graves Hurley, American Electronics Association, *Letter Re Comments on the Proposed Regulations on the Treatment of Employee Stock Options For Qualified Cost Sharing Arrangements*, TAX NOTES TODAY, Oct. 28, 2002, at 3.

[14] *Id.* at 2.

[15] Apple Inc., Annual Report (Form 10-K), at 39, 64 (Sept. 26, 2015), https://www.sec.gov/Archives/edgar/data/320193/000119312515356351/d17062d10k.htm [https://perma.cc/EBZ8-R233] (reporting that of the company's over $8 billion of research and development expense, $1.5 billion was from stock compensation expense).

[16] Alphabet Inc., Annual Report (Form 10-K), at 4 (Dec. 31, 2015), https://www.sec.gov/Archives/edgar/data/1288776/000165204416000012/goog10-k2015.htm [https://perma.cc/8X6L-REVW] (reporting that of the company's over $12 billion of research and development expense, over $2.5 billion was stock compensation expense).

[17] *Id.* at 92.

actually a group of hundreds of entities, or "boxes"[18] ultimately owned at the top by one entity, which is usually a public corporation. Practitioners call companies within this group related or commonly controlled companies.[19] These hundreds of boxes constantly transfer goods and services between one another. For each of these related party transfers, a price must be set—this is known as the "transfer price." If an inappropriate price is set; one box has too much profit, while another box has too little—and avoids tax. The owner at the top is generally agnostic as to *which* box books profit (or loss) from these internal transactions because, ultimately, it owns all of them. Layer on international borders between these boxes—and the different tax rates imposed by different countries—and there is huge incentive for the box in the lowest tax jurisdiction to book as much group profit as possible. The United States is frequently on the losing end of this dynamic because the United States has one of the world's highest corporate tax rates,[20] while other countries charge a 0% corporate income tax rate.[21] Understanding this dynamic, governments around the world have called for an end to abusive profit shifting practices.[22]

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[18] The term boxes is a reference to how the multiple entities are depicted on a corporate organizational chart, which lays out the ownership structure for a group of related companies.

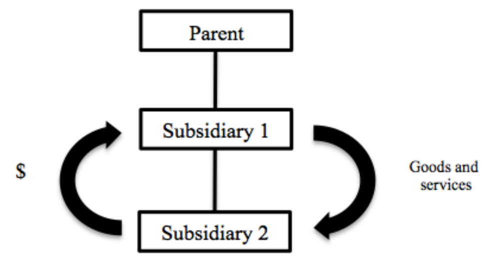
[19] Commonly controlled, or related, companies is a term of art in transfer pricing because I.R.C. § 482 applies only if organizations are "owned or controlled directly or indirectly by the same interests." JAMES S. EUSTICE & THOMAS BRANTLEY, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 13.20[3][a] (2016) (quoting I.R.C. § 482 (2012)). Commonly, this occurs when one company owns another company. The term "multinational" indicates that the group includes companies that are incorporated or otherwise residents of countries outside the United States. Companies that are not part of the same ownership group are called unrelated companies. Parent company indicates that one company owns another company. The company owned by a parent company is referred to as a subsidiary. Parent and subsidiary companies are commonly controlled or related for purposes of I.R.C. § 482. *Id.* ¶ 13.20[3][b].

[20] KYLE POMERLEAU, TAX FOUND., CORPORATE INCOME TAX RATES AROUND THE WORLD 2 (2014), http://taxfoundation.org/sites/taxfoundation.org/files/docs/FF436_0.pdf [https://perma.cc/W7Q9-LK82].

[21] For example, the Cayman Islands has a 0% corporate tax rate. *Id*. at 4. The Cayman Islands was the location of the subsidiary in question in *Altera*. 145 T.C. 91, 92 (2015), *appeal docketed*, No. 16-70497 (9th Cir. Feb. 23, 2016).

[22] LOWELL & BRIGER, *supra* note 5 ¶ 2.02[22][f][i] (noting that the Organization for Economic Co-operation and Development (OECD) leads this charge, but the United Nations and G-20 have separately announced their intention to address the issue). The OECD is an organization of thirty-five member countries, and includes Australia, Canada, the United States, Germany, Japan, Korea, Spain, and Turkey. *See Members and Partners*, OECD, http://www.oecd.org/about/membersandpartners [https://perma.cc/92K8-QVJA]. The OECD's main program to address this issue is its "Base Erosion and Profit Shifting" program that seeks to prevent tax planning strategies that "artificially shift profits to low or no-tax locations where there is little or no economic activity." *See About BEPS and the Inclusive Framework*, ORG. FOR ECON. CO-OPERATION AND DEV., http://www.oecd.org/tax/beps/beps-about.htm [https://perma.cc/HYX6-QHRA].

FIGURE 1: TRANSFER PRICING



For the United States, its general method for combatting abusive transfer pricing practices is through the single statutory law that governs it, Internal Revenue Code (I.R.C.) §482. Accompanying this statutory law is a voluminous set of Treasury regulations promulgated thereunder. The regulations, promulgated under I.R.C. §482, require U.S. companies to meet the "arm's length" standard to prevent abusive transfer pricing practices. This standard requires that related party transactions be consistent with the results of unrelated party transactions.[23] However, determining the results unrelated parties would reach is exceedingly difficult, particularly when determining the price of intangibles.[24] Beginning in the 1930s, and affirmed in regulations in the 1960s, the comparable uncontrolled transaction (CUT) method took precedence for determining prices for the transfer of tangible products.[25] This method works well when readily comparable transactions exist, such as when homogenous manufactured goods are sold broadly to both unrelated and related parties; however, it is much less helpful for unique, innovative goods or services, particularly intangible property where readily comparable products do not exist.[26] Recognizing this, Congress requested that Treasury overhaul the existing regulations in the late 1980s. This resulted in the 1994 regulations that required taxpayers to use the "best" of five potential methods which generates the most "reliable" arm's length

[23] Treas. Reg. § 1.482-1(b) (2015); *see infra* Sections II.C–E.

[24] A Study of Intercompany Pricing, I.R.S. Notice 88-123, 1988-2 C.B. 458, 460 [hereinafter Whitepaper] ("Because of the absence of comparables in many cases, intangible transfers generally are the most problematic of adjustments due to the inherent difficulty of valuing intangibles under the existing regulations.").

[25] Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 99, 108 (1995).

[26] *See supra* note 24.

price. Determining which method is "best" requires analyzing the comparability of the unrelated and related transactions in at least five suggested aspects: risks, functions, contractual terms, economic conditions, and property or services.

The purpose of this Note is to close the hole left by *Altera* and prescribe a method for Treasury to promulgate a regulation that would require multinational companies engaged in cost-sharing agreements to share at least a portion of stock-based compensation expenses.[27] This Note will establish that, contrary to what other commentators have suggested, Treasury is not limited to adopting "strict" comparable transaction transfer pricing regulations.[28] In addition, under the existing framework of the arm's length standard, Treasury can pass a new regulation similar to the one struck down by *Altera*.[29] To satisfy the requirements of the APA's notice-and-comment rulemaking,[30] Treasury must provide detailed responses to comments received from the public and demonstrate adequate reasoning in a statement of basis and purpose. This Note provides an argument Treasury could have put forth to address the major comments that the Tax Court ruled Treasury inadequately engaged with when the rule was promulgated.[31] The proposed response argues that sharing expenses indexed to stock performance is incomparable between related and unrelated parties because of their different levels of risk,[32] and thus is an inappropriate basis for making an arm's length determination.[33] Further,

[27] The decision also calls into question whether an unknown number of current regulations are invalid because Treasury often has not complied with APA procedures. *See* Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1154 (2008) (describing a sample study that concluded 40% of Treasury regulations passed between 2003 and 2005 failed to follow some procedural requirement of the APA). The possible implication or resolution of this issue are beyond the scope of this Note.

[28] *See* Gupta, *supra* note 9, at 1, 4 (noting that unless the IRS can "persuade Congress to amend the statute," the Treasury cannot likely undo the "result in *Altera* by simply going through another notice and comment process").

[29] *Id.*

[30] *See infra* Section I.B.

[31] The most damaging comments received provided evidence that unrelated parties in similar cost-sharing agreements never shared stock-based compensation expenses. The taxpayer then argued that requiring related parties to share an expense unrelated parties never shared violated transfer pricing's arm's length standard. Altera Corp. v. Comm'r, 145 T.C. 91 (2015), *appeal docketed*, No. 16-70497 (9th Cir. Feb. 23, 2016).

[32] Related companies under common control can use basic management techniques to affect their own stock price, so they have a level of control over stock compensation expenses that reduces risk to price fluctuations that unrelated companies simply will never have, and cannot replace. *See infra* Section III.D.

[33] One commentator suggested that when related parties "incur costs that by their nature wouldn't be shared," the arm's length result may have to be hypothesized to determine an arm's length price. *See*

Treasury can demonstrate adequate basis for this regulation if Treasury can provide evidence that related companies share a smaller percentage of *total* employee compensation than unrelated companies do in similar arrangements. The purpose of such a regulation would be to eliminate this difference. Eliminating this difference achieves two things: (1) it creates results that are "consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction,"[34] as required by the arm's length standard and (2) it prevents the "evasion of income taxes" as required by the statutory language of I.R.C. § 482.

This Note proceeds as follows: Part I will describe background information regarding transfer pricing, the APA, Treasury's related rulemaking authority, and the *Altera* case. Part II will describe the historical and current construction of the arm's length standard, including how the Tax Court applied the arm's length standard in a similar case that preceded *Altera*, *Xilinx*.[35] Part III will dispose of the misconception that the arm's length standard is either statutorily required to adhere to a strict comparable method, or that Treasury lacks the authority to redefine arm's length. The conclusion of Part III is helpful to this Note's ultimate argument because the 1994 regulation's new definition of the arm's length standard focuses on the *results* unrelated taxpayers would reach, and thus allows Treasury to select *total* employee compensation as the basis for comparison between related and unrelated parties, rather than stock-based compensation itself. Finally, Part IV provides responses to the comments the Tax Court held in *Altera* were inadequately addressed. Part IV also proposes a general argument to satisfy *State Farm*'s reasoned decisionmaking standard under the APA to promulgate a new regulation that requires related parties that participate in cost-sharing agreements to share at least a portion of stock-based compensation.

I. BACKGROUND: TRANSFER PRICING, THE APA, AND *ALTERA*

This Part will provide background information that at first blush may seem unrelated, but is necessary to understand the holding of *Altera*. First,

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Richard W. Skillman, *The Problems with* Altera, 150.3 TAX NOTES 347, 351 (2016) ("When commonly controlled parties incur costs that by their nature wouldn't be shared by unrelated parties, there are no truly comparable cost-sharing transactions between unrelated parties [and] in the absence of unrelated party comparables, the arm's-length standard may have to be applied . . . by hypothesizing the result of that arm's-length dealing.").

[34] 6 C.F.R. § 1.482-1(b) (2015). This Note proposes that this disparity likely exists because of the differing incentives of the two parties in regards to how to compensate employees that participate in cost-sharing agreements. See example in Section I.A.

[35] Xilinx, Inc. v. Comm'r (*Xilinx I*), 125 T.C. 37 (2005), *rev'd*, 567 F.3d 482, 497 (9th Cir. 2009), *aff'd*, 598 F.3d 1191, 1197 (9th Cir. 2010).

this Section I.A will provide additional information regarding transfer pricing as briefly referenced in the Introduction, and an overview of the specific cost-sharing agreements at issue in *Altera* that fall within the general umbrella category of transfer pricing. Next, Section I.B will provide background information on the APA. Finally, Section I.C will describe Treasury's related rulemaking authority, and the standards Treasury must meet in order to pass regulations that have the force of law.

A. Transfer Pricing and Cost-Sharing Agreements

In order to understand the fundamentals of transfer pricing, consider the following example. Related parties are agnostic as to which one books a profit because the same shareholders own all of the group's earnings. If one party, A, is incorporated in a high-tax jurisdiction and owns B, which is incorporated in a low-tax jurisdiction, the group of companies would want B to earn all their profit because it would reduce total tax owed. In this example, A and B, which are related parties, want to sell goods or services to C. A makes widgets that cost $100 to produce, and they can sell to C for $200, resulting in a $100 profit. That $100 profit is normally taxed at 40% and thus would leave shareholders with $60 after-tax profit. But if A decides to sell its widgets to B for $105, it would leave A with a profit of $5, and after applying a 40% tax rate A would have $3 after-tax profit. B could then sell to C for $200, which, after subtracting their $105 cost to purchase from A, leaves them with a $95 profit. B is taxed at 0% and so B earns an after-tax profit of $95. Therefore, in this scenario total after-tax profit for the group is $95 plus $3, or $98. So simply by placing B in a low-tax jurisdiction, and having them sell to an unrelated party C, the shareholders of A and B have increased after-tax profit by $38, or 63%.

This seems dramatic, but this can happen in transfer pricing if there are not clear rules to stop this type of manipulation. The 40% tax rate A normally pays is similar to the tax rate of the United States, and there are tax haven countries that do not charge any corporate income tax at all, similar to B's country.[36] A would never sell to an unrelated, uncontrolled party for such a low price though, and therefore the United States Tax Code, under § 482, grants the Commissioner of the Internal Revenue Service (Treasury) the right to reallocate income between related parties.[37] Treasury has published hundreds of pages of regulations in an attempt to

[36] *See supra* note 20–21.

[37] I.R.C. § 482 (2012).

provide structure as to when it will make these allocations among related parties.[38]

Now let us take the prior example a step further, and look at how transfer pricing interacts with cost-sharing agreements. Recall that the cost-sharing agreements allow a foreign subsidiary (or domestic subsidiary) to reimburse a U.S. parent company for the R&D costs it incurred in return for an ownership right in the assets developed.[39] The reimbursement from the foreign subsidiary is taxable income in the United States. For related parties in cost-sharing agreements, every dollar of employee compensation in the form of stock-based compensation, instead of other forms of employee compensation, provides a fantastic tax benefit. The company gets a deduction for the stock compensation that reduces its taxable income,[40] and it is not required to receive a payment from its foreign subsidiary, which also reduces its taxable income.

Consider the following simplified example. U.S. parent company (USP) and its subsidiary enter a cost-sharing agreement where foreign subsidiary (FS) pays USP for USP's expenses to develop new software, and in return FS owns half the rights to the software.[41] USP's only expense is a single employee who is paid a $200,000 salary. Under a cost-sharing agreement where FS owns half the software, FS would have to pay USP half the employee salary, $100,000. The entire $100,000 payment would be taxable income in the United States. However, if USP restructures the employee's compensation to be half salary and half stock-based compensation, USP would still deduct the entire $200,000 and FS would only have to reimburse USP for $50,000. Thus, by shifting employee salary to stock compensation, USP has cut its taxable income in half. On the other hand, unrelated parties do not have this same incentive because they prefer $1.00 of expense reimbursement over the possible $0.40 tax benefit from

38 Reallocations consist of a primary adjustment wherein the IRS may allocate items of income, deductions, credits, or any item affecting taxable income by increasing or decreasing the amount attributed to any related party member. Treas. Reg. § 1.482-1(a)(2) (2015). Using the example above, this could require A to recognize $100 profit for its sale to B because that is the price that C, an unrelated party, was willing to pay for it.

39 *See* Treas. Reg. § 1.482-7(a)(1). The above is a simplified explanation. Specifically, Treasury Regulation § 1.482-7(a)(1) requires participants to share "intangible development costs" in proportion to their "reasonably anticipated benefits" from the agreement. Simply put, if the foreign subsidiary has the right to half of the projected future income of an intangible asset being developed in a cost-sharing agreement, they have to contribute half the cost to develop it. *Id*.

40 *See infra* note 170.

41 This is a simplified example. Specifically, in Treasury Regulation 1.482-7, companies in cost-sharing agreements must share "intangible development costs" in proportion to their "reasonably anticipated benefits" of the agreement. *See supra* note 39.

forgoing reimbursement.[42] In fact, unrelated parties have an incentive to keep employees paid as much as possible by salary in order to ensure their unrelated partner is paying as much of the expense as possible. Therefore, without clear transfer pricing rules to require related parties engaged in cost-sharing agreements to share stock-based compensation, they can drastically reduce their taxable income in a manner that is inconsistent with the results unrelated parties would reach.

B. The Administrative Procedure Act of 1946

Next, to understand why the regulation was invalidated in *Altera*, it is necessary to understand the basics of the APA. The administration of our modern federal government requires Congress to write federal statutes and other branches of government to interpret them.[43] When administrative agencies like Treasury interpret federal statutes, they issue nonlegislative interpretive rules that do not have the force of law but may be provided deference by courts.[44] At times, Congress goes a step further and delegates legal authority to administrative agencies, and allows them to issue legislative rules, which have the force of law and are binding on courts, citizens, and the agency.[45] The APA governs all administrative agency rulemaking processes.[46]

Under § 553 of the APA, there are three procedures for issuing a rule.[47] First, agencies may promulgate interpretive rules that are not binding on courts by issuing and publishing the rule in the *Federal Register*—without following any APA procedure.[48] By contrast, substantive

[42] Reducing the amount reimbursed by unrelated parties is a dollar-for-dollar loss. Although this also reduces taxable income for the unrelated party, they only receive a benefit proportionate to the applicable tax rate on that foregone reimbursement. Thus, at a tax rate of 40%, for each $1.00 not reimbursed, a related company loses $0.60.

[43] Ellen P. Aprill, *The Interpretive Voice*, 38 LOY. L.A. L. REV. 2081, 2081 (2005) ("Under current Supreme Court jurisprudence, sometimes courts assume primary interpretative authority; at other times, that task falls to the executive branch in the form of an administrative agency.").

[44] *Id.* at 2082 (quoting Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 (1984)) (noting that under *Chevron*'s two-step analysis, if a "'statute is silent or ambiguous,' . . . courts [should] defer to the agency so long as 'the agency's answer is based on a permissible construction of the statute'").

[45] RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 408, 419, 471 (5th ed. 2010); *see* Peter L. Strauss, Comment, *The Rulemaking Continuum*, 41 DUKE L.J. 1463, 1464 (1992).

[46] The Administrative Procedure Act of 1946, 5 U.S.C. §§ 551–559 (2012).

[47] PIERCE, *supra* note 45, at 557.

[48] PIERCE, *supra* note 45, at 474. See *infra* Section I.C for discussion as to how the Treasury previously asserted that all of its regulations are interpretative rather than legislative.

legislative rules, except for those specifically exempt,[49] require following one of two procedures.[50]

The two procedural avenues for issuing legislative rules are formal and informal rulemaking.[51] The most important and interesting procedure is informal rulemaking—known colloquially as "notice-and-comment rulemaking," because formal rulemaking has become increasingly rare.[52] Notice-and-comment rulemaking requires: (1) issuing public notice of the proposed rule; (2) receiving and considering comments from all interested persons; and (3) issuing the final rule, which includes stating the agency's basis and purpose.[53] As stated above, an agency that passes a rule following the notice-and-comment procedure can create an instrument with the force of law that binds courts, citizens, and the government itself.[54] However, the APA compels courts to determine whether a legislative rule is valid and "set aside [an] agency action" that is "arbitrary" or "capricious."[55]

Whether adequate notice has been issued may be a contentious issue;[56] however, the most common basis for judicial reversal comes when a court determines an agency did not provide an adequate "statement of basis and purpose."[57] The Supreme Court has ruled a statement of basis and purpose is adequate if it finds evidence of "reasoned decisionmaking."[58] The application of the reasoned decisionmaking standard follows the statutory requirements of § 553, and thus there must be evidence of the agency's reasoned decisionmaking in response to comments it received.[59] Similarly,

[49] Section 553(a) exempts from all APA procedures (1) military and foreign affair rules and (2) agency management rules. § 553(a). Section 553(b) specifically exempts from notice-and-comment procedures (1) "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice" and (2) "when the agency for good cause finds . . . that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest." *Id.* § 553(b).

[50] As opposed to purely procedural rules which are exempt under § 553(b)(A). PIERCE, *supra* note 45, at 557.

[51] *Id.* at 557–58.

[52] *Id.* at 558.

[53] § 553(c); *see also* PIERCE, *supra* note 45, at 557.

[54] Strauss, *supra* note 45, at 1466–67.

[55] § 706(2)(A); PIERCE, *supra* note 45, at 559.

[56] PIERCE, *supra* note 45, at 572 (explaining that challenges to this requirement generally come when: (1) a large divergence existed between the proposed action and the agency final action such that an affected party had no notice of a critical element of the final action and (2) the agency relied on data not known until it announced its final action).

[57] *Id.* at 593.

[58] Motor Vehicle Mfrs. Assn. of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43, 52 (1983); PIERCE, *supra* note 45, at 600.

[59] PIERCE, *supra* note 45, at 594, 600.

there must be evidence of reasoned decisionmakring in the agency's statement of basis and purpose.[60]

First, reasoned decisionmaking requires proportionately detailed responses to comments received from interested persons during the notice-and-comment period.[61] For instance, if a comment criticizes a characteristic of the proposed rule, but the agency retains that characteristic without a relatively detailed response to the criticism, a reviewing court will likely find the rule unlawful.[62] Next, the agency must demonstrate adequate reasoning in its statement of basis and purpose for the rule, or put another way, it must identify the source of legislative authority for the rule and why the rule is necessary.[63] Thus, this statement of basis and purpose encompasses two aspects. First, "[h]ow well has the agency anchored the rule in the language of the statute it purports to implement?" Second, if the agency's reasoning depends on a pattern of facts, "how well has the agency supported its belief in the existence of that pattern of facts?"[64]

In *State Farm*, the Supreme Court defined whether an agency meets the reasoned decisionmaking standard as follows:

> [A]n agency rule would be arbitrary and capricious if the agency has [1] relied on factors which Congress has not intended it to consider, [2] entirely failed to consider an important aspect of the problem, [3] offered an explanation for its decision that runs counter to the evidence before the agency, or [4] is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[65]

State Farm stated and applied the Court's reasoned decisionmaking standard in a way that seems to impose only a "modest burden of explanation."[66] However, this standard is more difficult for an agency that wants to issue a major rule because its statement of basis and purpose must include all statutory factors considered in the decision, every important aspect of the problem, and responses to all counterevidence that typically comes from interested parties' criticisms during the comment period.[67] In fact, some agencies have concluded that it would take them a decade to

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[60] *Id.*

[61] *Id.* at 594.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] Motor Vehicle Mfrs. Assn. of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

[66] PIERCE, *supra* note 45, at 599.

[67] *Id.* at 600.

issue a major rule, which critics suggest deters agency rulemaking due to the significant staff resources and time required.[68]

C. *Treasury's Rulemaking Authority*

In an average year, Treasury promulgates hundreds of rules under the I.R.C.[69] Treasury contends the majority of its regulations are interpretative, and thus nonlegislative, making them exempt from the APA notice-and-comment requirements.[70] If so, the majority of Treasury regulations would not hold the force of law. This is significant because agency rules that do not hold the force of law will not be granted *Chevron* deference[71] by courts as ruled in *Mead*.[72] However, even if they are not granted the more generous Chevron deference, agency interpretative rules are still afforded limited deference under *Skidmore*.[73] Even with the reduced deference courts may afford its regulations, Treasury likely prefers courts to treat its rules as interpretative because it allows the agency to avoid the huge resource expenditure that true notice-and-comment rulemaking implicates.[74]

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[68] *Id.* at 601.

[69] *See* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1741 (2007); *see also* Hickman, *A Problem of Remedy*, *supra* note 27, at 1154.

[70] INTERNAL REVENUE MANUAL § 32.1.1.2.6.1 (Sept. 23, 2011), https://www.irs.gov/irm/part32/irm_32-001-001.html#d0e470 [https://perma.cc/Y7L8-VGAW] ("The Administrative Procedure Act (APA) exempts interpretative rules from the APA's notice and comment requirements. . . . Most IRS/Treasury regulations are considered interpretative."); *see also* Hickman, *Coloring Outside the Lines*, *supra* note 69, at 1729 (stating Treasury contends its regulations are exempt from notice and comment because they are interpretative in character).

[71] The *Chevron* deference standard requires a two-step inquiry where the court must first ask if the statutory meaning is facially clear from the statute, and if so, the court "must give effect to the unambiguously expressed intent of Congress." Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 (1984). But if the congressional statute is not clear, the court is to defer to an agency's reasonable interpretation. *Id.* (defining a reasonable decision as one that "is based on a permissible construction").

[72] United States v. Mead Corp., 53 U.S. 218, 226 ("We hold that administrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.").

[73] *Id.* at 227–28. *Skidmore* deference is described as proportional to the agency position's power to persuade. *See* Skidmore v. Swift & Co. 323 U.S. 134, 140 (1944) (discussing how the weight afforded to agency interpretations depends on "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade").

[74] This is particularly true in the case of transfer pricing regulations, which are promulgated under the extremely sparse I.R.C. § 482, and provide almost no direct rules.

But one scholar recently contended—and the Tax Court in *Altera* ruled—that the broad authority granted under I.R.C. § 7805(a) to the Secretary of Treasury to "prescribe all needful rules and regulations for the enforcement of" the I.R.C. means such rules are legislative in nature, and therefore must comply with APA notice-and-comment procedures.[75] While this could be a disastrous outcome for Treasury,[76] the problem is not entirely dire because Treasury has generally complied with notice-and-comment procedures despite contending its regulations were exempt.[77] As a result, some compliant Treasury regulations arguably have received a bump in authority. However, the greater risk is that potentially hundreds of regulations are invalid for sloppy compliance with APA procedure, and a plausible opportunity exists for "unhappy taxpayers to challenge [such] regulations . . . for their procedural failings."[78]

II. *ALTERA* AND THE ARM'S LENGTH STANDARD

A. Altera *Overview*

In *Altera*, the Tax Court invalidated Treasury Regulation § 1.482-7(d)(2).[79] The court held the regulation was a legislative rule, and then found it arbitrary and capricious and therefore invalid under the APA.[80] The court held that Treasury failed to satisfy *State Farm*'s reasoned decisionmaking standard in the agency's final statement of the regulation's basis and purpose.[81] Specifically, the court found that the regulation's "final rule lack[ed] a basis in fact," failed to connect with evidence found, failed to respond to significant comments, and was contrary to the evidence before it.[82]

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75 Altera Corp. v. Comm'r, 145 T.C. 91, 116–17 (2015), *appeal docketed*, No. 16-70497 (9th Cir. Feb. 23, 2016) (quoting I.R.C. § 7805(a) (2012)); Hickman, *Coloring Outside the Lines*, *supra* note 69, at 1763–64.

76 Hickman, *supra* note 27, at 1154 & n.4. Despite prior voluntary notice-and-comment procedures, a recent study concluded 40% of Treasury regulations passed from 2003 to 2005 failed to follow some procedural requirement of the APA. *Id.*

77 *Id.* at 1158.

78 *Id.* at 1154.

79 *Altera*, 145 T.C. at 133; Treas. Reg. § 1.482-7(d)(2) (2015).

80 *Altera*, 145 T.C. at 133. See *supra* note 70 for a discussion about whether all Treasury rules are legislative and thus subject to the APA.

81 Although the court lists four reasons, in essence, they all relate to the Treasury's failure to respond to comments because those comments introduced evidence that the rule "failed to rationally connect . . . with the facts." *Altera*, 145 T.C. at 133.

82 *Id.*

Altera is a multinational group of commonly controlled (i.e., related) companies[83] that develop high-tech devices and sell the related hardware and software.[84] The case resulted from the IRS's adjustment to U.S. parent company's[85] (Altera U.S.) taxable income for approximately $80 million.[86] The IRS asserted the U.S. parent company should have been paid more by a company it owned[87] that was located in the Cayman Islands, Altera International (Altera Cayman). In technical terms, the two companies entered a cost-sharing agreement wherein Altera Cayman and Altera U.S. agreed to "pool resources" to further develop IP previously created by Altera U.S.[88] In conjunction with the cost-sharing agreement, Altera Cayman had also licensed the right to exploit the IP previously created by Altera US in all markets except the U.S. and Canada.[89] These cost-sharing agreements, by definition, allowed Altera Cayman to also exploit the newly developed IP subject to the cost-sharing agreement without having to make separate royalty payments to Altera U.S.[90] While this may seem complicated, simply put, Altera Cayman agreed to pay Altera U.S.: 1) royalties for the rights to IP previously developed by U.S.; and 2) costs to further develop that IP, in return for ownership-type rights in the newly developed IP. From a high-level perspective this amounts to the Altera multinational group migrating ownership of their IP from a U.S. company (Altera U.S.) to a Cayman Islands company (Altera Cayman).

This brings us to the major question at issue in this case: which was whether Altera U.S. must be reimbursed for stock compensation paid to U.S. employees that perform R&D in connection with the cost-sharing

[83] See *supra* note 19 for the definition of controlled, or related, companies.

[84] *Altera*, 145 T.C. at 93.

[85] Parent company indicates a company that owns another company. The company owned by a parent company is referred to as a subsidiary. Parent and subsidiary companies are commonly controlled or related for purposes of I.R.C. § 482 (2012).

[86] *Altera*, 145 T.C. at 94.

[87] Also referred to as a related party, a controlled company, or a subsidiary company.

[88] Intangible assets in this case were related to intellectual property such as patent, copyright, and trade secrets developed during research and development. *Altera*, 145 T.C. at 93–94.

[89] *Id*. at 93.

[90] Treasury Regulation § 1.482-7(a)(1) requires participants to share "intangible development costs" in proportion to their "reasonably anticipated benefits" from the agreement. So, if the foreign subsidiary has the right to half of the projected future income of an intangible asset being developed in a cost-sharing agreement, they have to contribute half the cost to develop it. *See* Treas. Reg. § 1.482-7(a)(1). Furthermore, each participant must receive a "non-overlapping interest in the cost shared intangible without further obligation to compensate another controlled participant for such interest." *See* Treas. Reg. § 1.482-7(b)(4)(i). And each participant shall be "entitled to the perpetual and exclusive right to the profits from transactions . . . to the extent such profits are attributable to such interest in the cost shared intangibles." *Id*.

agreement.[91] Specifically, § 1.482-7(d)(2) required Altera Cayman to reimburse Altera U.S. for *all* employee compensation, including stock compensation, paid to employees that worked to make the intangible assets,[92] but Altera did not include those employee's stock compensation expenses.[93] Altera disputed that the Cayman company should pay a portion of Altera U.S.'s employee stock-based compensation on grounds that the rule itself was invalid since Treasury failed to respond to significant comments under the APA during their rulemaking procedures.[94]

When Treasury was promulgating this rule, they received comments from interested parties, and the most significant issue raised by the comments included evidence that unrelated parties under similar agreements had never agreed to share stock-based compensation costs.[95] This is significant, because per § 1.482-1(b), transactions between related parties meet the arm's length standard if the results are consistent with results that would have been realized by uncontrolled parties to "comparable transactions under comparable circumstances."[96] As the court stated here, the evidence provided by commentators that unrelated parties did not share stock compensation cost was evidence that a rule requiring related parties to do so is inconsistent with the arm's length standard articulated in Treasury Regulation § 1.482-1(b).[97] As the court stated, this possible inconsistency was never adequately addressed and the final statement of basis and purpose Treasury offered was a bare "ipse dixit"[98] statement that "[p]arties dealing at arm's length in such an arrangement . . . would not distinguish between stock-based compensation and other forms of compensation."[99] Indeed, the court's characterization seems correct because Treasury's statement does not coincide with the evidence commentators provided, and Treasury offered no other support. In fact, the evidence commentators provided directly contradicts Treasury's statement because it showed that unrelated parties had specifically distinguished

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[91] *Altera*, 145 T.C. at 91.

[92] Treas. Reg. § 1.482-7(d)(2) (2015).

[93] *Altera*, 145 T.C. at 93.

[94] *Id.* at 120.

[95] *Id.* at 127–30. The court also recognized an additional minor argument by economic professors that "there is no net economic cost to a corporation or its shareholders from the issuance of stock-based compensation." *Id.* at 129.

[96] § 1.482-1(b)(1).

[97] *Altera*, 145 T.C. at 133–34; *see also* Treas. Reg. § 1.482-1(b)(1) ("[T]he standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."). See *supra* note 83 for a definition of controlled parties.

[98] *Altera*, 145 T.C. at 133.

[99] *Id.* at 109.

stock-based compensation from other compensation since that was the only type they had not shared. Therefore, the court correctly concluded that the regulation was invalid because it "lack[ed] a basis in fact," failed to connect with evidence found, failed to respond to significant comments, and was contrary to the evidence before it.[100]

Treasury's reasoning that sharing stock-based compensation costs was consistent with the overarching arm's length standard may have failed in this instance, but the real question is: *Could* Treasury have made an alternative argument that satisfied *State Farm*'s reasoned decisionmaking standard? The preceding Section outlined the court's reasoning in *Altera*. This provides the foundation of this Note's prescriptive claim as to how Treasury can promulgate a regulation similar to the one stuck down. Recall that *State Farm* requires an agency to exercise reasoned decisionmaking in both its responses to comments and in its general statement of the regulation's basis and purpose. First, the major criticism that unrelated parties do not share stock-based compensation costs does not indicate the regulation violates the arm's length standard. While this may have been a more difficult comment to respond to under the "strict" comparable construction of the arm's length standard, the broader understanding of arm's length implemented by the 1994 regulations provides the necessary support. Under the 1994 regulations, one of the primary considerations for satisfying the arm's length standard requires looking at the comparability of the unrelated and related party transactions. In regards to stock compensation, whether unrelated parties share these costs is not comparable because unrelated and related parties have fundamentally different levels of risk and uncertainty; unrelated parties have no ability to manage the other party's stock price, while related parties have the ability to manage their own stock price. Moreover, the broader arm's length standard implemented by the 1994 regulations requires the *results* of related party transactions to be consistent with unrelated party transactions, not the *method*. These two characteristics of the 1994 regulations' arm's length standard provide the detail necessary to satisfy *State Farm*, the first hurdle of the APA, and thus lawfully address the comments received. In order to further develop this concept, the following Section defines the arm's length standard's historical and current legislative construction.

B. The Evolving Arm's Length Standard

The arm's length standard is a concept that was first introduced in 1935 by Treasury to provide guidance to taxpayers as to when it will adjust

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[100] *Id.* at 133.

a taxpayer's taxable income under I.R.C. § 482.[101] The meaning of the arm's length standard has been a contentious issue for most of its eighty-year history.[102] At its inception, courts considered it a broad concept focused on whether an allocation was necessary "to reflect . . . income."[103] However, beginning in the early 1960s, courts began to narrowly construe the arm's length standard and only focus on finding comparable transactions (strict comparable method)[104] between uncontrolled parties to support or contradict a finding that the taxpayer has met the standard.[105]

In 1986, Congress recognized that the blind focus on strict comparable transactions was an issue and asked Treasury to review the current practices for potential changes.[106] This led to the issuance of new regulations in 1994. These new regulations sought to supersede unfavorable court decisions and replace the strict comparable transaction approach with a results-driven approach.[107] Per the best method rule, the method used must be the one that "provides the most reliable measure of an arm's length *result*."[108] Thus, the best method rule emphasizes a results-driven approach and requires taxpayers to determine which of the now-

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[101] LOWELL & BRIGER, *supra* note 5, ¶ 2.02[8].

[102] *See* Avi-Yonah, *supra* note 25. This article traces the history of the arm's length standard and asserts that the original interpretation was a broad construction that focused on a "clear reflection of income" of a taxpayer. *Id.* at 98 (quoting Asiatic Petroleum Co. v. Comm'r, 31 B.T.A. 1152, 1159 (1932)). Then the interpretation became unduly narrowed by the courts in the 1960s and strictly focused on the existence of a comparable uncontrolled transaction until prompted by Congress in 1986 to revise, when it was broadened to indicate a "transfer pricing continuum" that uses multiple methods other than strict comparable transactions to reach "results . . . the same as those that would have been reached between unrelated parties." *Id.* at 94.

[103] *See, e.g.*, Nat'l Sec. Corp. v. Comm'r, 137 F.2d 600, 602 (3d Cir. 1943) (inquiring whether allocation was necessary "in order clearly to reflect the income"). In *Seminole Flavor Co. v. Commissioner*, the Tax Court held for the taxpayer and stated the arm's length determination of a transaction is determined by whether it was "fair and reasonable." 4 T.C. 1215, 1232–33 (1945). In fact, the court seemed to rebuff whether a comparable transaction existed to support an arm's length determination and stated "[w]hether any such business agreement would have been entered into by petitioner with total strangers is wholly problematical." *Id.* at 1233.

[104] This interpretation will be referred to as "strict comparable" throughout this Note.

[105] *See* Avi-Yonah, *supra* note 25, at 116 (first citing U.S. Steel Corp. v. Comm'r, 617 F.2d 942, 950–51 (2d Cir. 1980) (admitting that the transactions were fundamentally different but still holding them as comparable); and then quoting *id.* ("To say that Pittsburgh Steel was buying a service from Navios with one set of expectations about duration and risk, and [U.S.] Steel another, may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a broadly drawn statute.")).

[106] H.R. REP. NO. 99-841, pt. 2, at 638 (1986) (Conf. Rep.) (noting that "conferees are also aware that many important and difficult issues under section 482 are left unresolved" and inviting the Treasury to study intercompany pricing rules and consider whether existing regulations could be modified).

[107] LOWELL & BRIGER, *supra* note 5, ¶ 1.02.

[108] *See* Avi-Yonah, *supra* note 25, at 145 (quoting Treas. Reg. § 1.482-1(c)(1) (2015)).

available five methods a taxpayer should use to determine an arm's length price.[109]

The following Section will outline each of these five alternatives. These alternatives are relevant because they represent Treasury's broader interpretation of the arm's length standard.

C. *The Five Arm's Length Standard Methods*

The 1994 regulations introduced the concept of the best method rule, which defined the allowable methods for determining an arm's length transfer price and made it clear that strictly relying on comparable transactions was a thing of the past.[110] Because of the 1994 regulations, it is best to understand the arm's length method as an umbrella term under which strict comparables is one possible method. The first three of the five possible methods are often referred to as "traditional" methods because they more strictly rely on comparable transactions for the basis of their price.[111]

First, the "comparable uncontrolled price" method relies on pricing from two unrelated parties selling the same specific product.[112] Next, there is the "cost plus" method, where a normal profit margin of uncontrolled parties in a similar industry is determined and then applied to the costs of the controlled party to determine the appropriate price.[113] Similar to "cost plus" is the "resale price," which also determines an appropriate profit margin, but applies to a seller rather than a manufacturer.[114] The traditional methods work well in the manufacturing world, where many producers provide the same products to customers.[115] However, they have little use in the high-tech development world, i.e., the space occupied by Altera, where unique products and services do not have readily available comparables.[116]

The last two methods were introduced by the 1994 regulations, and one loosely relies on an outside comparable, and the other is almost entirely internally derived. The "comparable profits" method uses an industry average profit for a broad group of corporations in a similar industry, and

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[109] *Id.* at 145–46.
[110] LOWELL & BRIGER, *supra* note 5, ¶ 1.02.
[111] *See* Avi-Yonah, *supra* note 25, at 91–92.
[112] *Id.* at 92.
[113] *Id.*
[114] *Id.*
[115] H.R. REP. NO. 99-426, at 423–26 (1985) (Conf. Rep.).
[116] *Id.* ("Many observers have questioned the effectiveness of the 'arm's length' approach of the regulations under section 482" where "[t]he problems are particularly acute in the case of . . . high-profit potential intangibles.").

then applies it to the cost of the controlled company in question.[117] Finally, the "profit split" method signals Treasury's willingness to almost completely depart from using comparable transactions to determine an arm's length price. The profit split method first analyzes the functions performed by each related party, then a market rate of return for each function is determined based on loose comparables, and finally, remaining residual profit is divided between the parties using a fairly flexible formula.[118] As a result of these disparate methods—particularly the introduction of the profit split method—it is clear the arm's length standard as defined in the 1994 regulations (and existing currently) does not require the existence of a specific uncontrolled comparable to support an adjustment made by Treasury.

D. Determining the Best Method by Degree of Comparability

The best method rule requires a taxpayer to use whichever among the five available methods "provides the most reliable measure of an arm's length result."[119] A taxpayer determines the reliability of a method by analyzing (1) the degree of comparability between controlled and uncontrolled transactions and (2) the quality of data and assumptions used.[120]

The comparability of transactions requires a taxpayer to assess the following factors: (1) functions, (2) contractual terms, (3) risk, (4) economic conditions, and (5) property or service.[121] The standard of comparability does not require identical transactions, but only that transactions "must be sufficiently similar that it provides a reliable measure of an arm's length result."[122] Taxpayers are further required to generally adjust the results for any difference in comparability, if possible,[123] and the adjustments "must be based on commercial practices, economic principles, and statistical analyses."[124] The IRS must determine the best method and comparability standards before a court can approve or deny the basis for an adjustment.[125]

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117 *See* Avi-Yonah, *supra* note 25, at 93.

118 *Id.* at 93–94.

119 Treas. Reg. § 1.482-1(c)(1) (2015).

120 *Id.* § 1.482-1(c)(2)(i).

121 *Id.* § 1.482-1(d)(1).

122 *Id.* § 1.482-1(d)(2).

123 It is possible to use the result even if adjustments cannot be made, but it reduces reliability. *Id.* § 1.482-1(d)(2).

124 *Id.*

125 The Tax Court opinion in *Altera* omits this analysis, for good reason, because the substance of the adjustment was not at issue, but rather whether the rule passed was valid to support the issue.

Section II.B described the history of the arm's length standard and clarified its current construction. Moreover, to satisfy the APA, the Treasury must provide detailed responses to all comments received. For the regulation struck down in *Altera*, the most significant criticism was that stock-based compensation should not be shared by related parties because Treasury did not provide evidence of unrelated parties sharing the same expenses. However, the broadened 1994 regulations' construction of the arm's length standard does not blindly rely on "strict" comparable transactions. Further, the primary factor for determining whether a particular unrelated transaction should be used to determine conformity with the arm's length standard is how comparable it is. As this Note will discuss in Part IV, sharing stock compensation between unrelated and related parties is not comparable due to the different levels of risk each party would assume. Finally, because the current construction of the arm's length standard focuses on the *results* of related party transactions rather than the *method*, total employee compensation may be used as the relevant point of comparison for an arm's length method to determine the expenses that should be shared. Therefore, if Treasury provides evidence that related parties compensate employees using stock compensation at a higher rate than unrelated parties, then *not* requiring related parties to share stock compensation would create a *result* inconsistent with the total employee compensation shared by related parties and thus violate the arm's length standard. The next Section describes a case that decided an issue almost identical to *Altera*, but was decided before the invalidated regulation was enacted. This case provides important background to the substance of the issue and the feasibility of reviving a related regulation not discussed in depth in *Altera*, because *Altera* was decided on procedural grounds, i.e., Treasury failed to satisfy the APA in its rulemaking procedure.

E. Xilinx v. Commissioner

In March 2010, the IRS battled with a taxpayer in a case almost identical to *Altera* where the IRS alleged a foreign subsidiary must pay for stock compensation expenses. However, in this case, the years adjusted were from 1996 through 1999, and therefore, the 2003 regulations that specifically required sharing stock compensation expenses were not at issue. The only question the court needed to answer was whether requiring the sharing of stock compensation expenses was consistent with the arm's length standard.

In an odd series of events, the Tax Court first ruled in the taxpayer's favor that the costs were not required to be shared, then the Ninth Circuit issued an opinion reversing the holding of the Tax Court.[126] However, the Ninth Circuit subsequently withdrew that holding eight months later and affirmed the original opinion of the Tax Court.[127] Under Treasury Regulation § 1.482-7(d) at that time, parties to an agreement were only required to share compensation paid to the group's R&D employees, and there was no specific mention of stock compensation expenses.[128] The taxpayer's experts provided evidence that no unrelated party had shared stock-based compensation expenses, and the court held that on its face, Treasury Regulation § 1.482-1, which requires all adjustments to be made on an arm's length basis, denied the IRS the ability to reallocate stock compensation expenses because there was no evidence that unrelated (uncontrolled) parties had ever shared them before.[129]

Although the court eventually agreed with the taxpayer, it is important to note two things. First, the court based its decision on statutory law in effect from 1996 to 1999 that did not include the updated regulation that required sharing stock compensation.[130] Next, the government's argument on this issue relied on the second sentence of § 482 to support the allocation.[131] However, this is problematic because the second sentence of § 482—known as the commensurate with income standard—has always been interpreted by Treasury as "consistent[] with the arm's length standard."[132] The government failed to provide a convincing argument as to how the allocation is consistent with the arm's length standard.[133] Because the government asserted only the commensurate with income standard as the basis for the allocation, the taxpayer's rebuttal that there was no evidence of unrelated parties sharing these costs was particularly damaging because the lack of evidence seems inconsistent with a "strict" comparable arm's length standard. However, unlike the government in *Xilinx*, this Note will argue in the following Part that requiring these costs to be shared *is* consistent with the arm's length standard despite the evidence from

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126 *Xilinx I*, 125 T.C. 37, 62–63 (2005), *rev'd*, 567 F.3d 482, 497 (9th Cir. 2009).

127 Xilinx, Inc. v. Comm'r (*Xilinx II*), 567 F.3d 482, 496–97 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010); Xilinx, Inc. v. Comm'r, 598 F.3d 1191, 1197 (9th Cir. 2010); *aff'g Xilinx I*, 125 T.C. 37 (2005).

128 Treas. Reg. § 1.482-7(d)(1) (as amended in 1999); I.R.S. Field Serv. Adv. 2000-03-010 (Oct. 18, 1999) (requiring that cost-sharing agreement participants share option-related expenses as well).

129 *Xilinx I*, 125 T.C. at 61.

130 *Id.* at 50.

131 Brief of Respondent at 86–87, *Xilinx I*, 125 T.C. 37 (2005) (No. 4142-01) (the government relying upon an assertion that the commensurate with income standard added after the 1986 revision to § 482 supports its position because the relative economic activities undertaken by the parties are consistent with the allocation).

132 *See* I.R.S. Chief Couns. Mem. AM-2007-007, at 1 (Mar. 23, 2007).

133 *Xilinx I*, 125 T.C. at 59.

unrelated parties. The following Part will demonstrate that sharing stock compensation has a fundamentally different level of risk, and therefore, whether unrelated parties share this specific type of employee compensation is irrelevant to the arm's length standard because the two circumstances are not comparable.[134]

III. REVIVING THE REGULATION

As mentioned, there is a misconception that the *Altera* decision requires any new transfer pricing regulations to adhere to a strict comparable arm's length method.[135] However, new transfer pricing regulations, like the 2003 regulation invalidated in *Altera*, do not require a strict comparable method to meet an arm's length standard under the current definition of § 1.482-1(b), which was revised by the 1994 regulations.

A. *Unrelated Taxpayers Evidence Not Determinative of Arm's Length*

As demonstrated in Part II, the arm's length standard is a construct of Treasury's own legislative rules,[136] rather than statutory authority.[137] Therefore, Treasury has the ability to amend any of its rules as long as it follows appropriate notice-and-comment procedures.[138] However, as long as Treasury Regulation § 1.482-1(b)(1) (201) in its current form is on the books, Treasury must adhere to the current definition of the arm's length standard in passing new transfer pricing regulations because the regulation states that the arm's length standard is "to be applied in every case."[139] And because it is a legislative rule, the government is similarly bound.[140] The

134 *See infra* Part III.

135 *See* Gupta, *supra* note 9 (noting that unless the IRS can "persuade Congress to amend the statute," the Treasury cannot likely "undo the result in *Altera* by simply going through another notice and comment process").

136 *See supra* Section II.D.

137 Some may argue that the existence of arm's length standard language in treaties with foreign countries complicates this analysis. Specifically, in *Altera*, there is no treaty between the United States and the Cayman Islands, and thus does not apply in this case. More broadly, most treaties do not attempt to define arm's length themselves but rather refer to incorporating the principle "reflected in the U.S. domestic transfer pricing provisions." DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL GAINS, art. 9, https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf [https://perma.cc/W9R2-Z66A]. Therefore, treaties themselves incorporate the Treasury definition of arm's length.

138 *See supra* text accompanying notes 45, 53–54.

139 Treas. Reg. § 1.482-1(b)(1) (2015).

140 *Id.*

last time § 1.482-1(b) was amended in 1994, Treasury introduced the best method rule with the addition of the phrase: "Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482-1(c)."[141] Therefore, under the 1994 regulations the best method rule applies to determine whether a transaction produces an arm's length result, and does not require blind reliance on transaction data between unrelated parties. As discussed above, to determine the best method, a taxpayer must determine how comparable potential transactions are in regard to five factors: (1) functions, (2) contractual terms, (3) risk, (4) economic conditions, and (5) property or service.[142] The existing best method standard requires the comparability of transactions, and if potential comparable transactions are not actually comparable, then taxpayers should not use them to evaluate whether the transaction produces an arm's length result.[143] Therefore, there is no need to change the definition of arm's length in order to require sharing stock compensation in circumstances similar to *Altera* because the existing standard is already flexible enough to accommodate such a rule.

As discussed in Part II, after the 1994 regulations, arm's length is best understood as an umbrella standard under which the strict comparable transaction analysis is one of five qualifying methods.[144] The current legislative rule defines the arm's length standard as requiring the result of a transaction between controlled taxpayers to be consistent with *results* uncontrolled taxpayers would achieve under the *same circumstances*.[145] The standard further recognizes that identical transactions are rarely available, and while it acknowledges an arm's length result will *generally* be determined by reference to comparable transactions under comparable circumstances, it by no means requires the basis of an arm's length method to be a comparable transaction.[146] Given the rule *requires* that arm's length be determined by reference to uncontrolled taxpayers under the *same* circumstances, but only *generally* by reference to uncontrolled taxpayers under *comparable* circumstances, it stands to reason that diverging from reference to uncontrolled taxpayers may occur when there are not sufficiently comparable circumstances.

141 *Id.*

142 *Id.* § 1.482-1(d).

143 *See supra* notes 112–13 and accompanying text.

144 *See supra* Sections II.D–E.

145 § 1.482-1(b)(1).

146 *Id.*

In fact, Congress's purpose for amending I.R.C. § 482[147] and urging Treasury to amend the definition of arm's length was to end the strict reliance on unrelated party transactions when circumstances are not sufficiently comparable.[148] Treasury complied with this mandate by redefining the arm's length standard as discussed above, introducing "nontraditional" pricing methods, and amending the best method rule to allow taxpayers to select from the five possible options to evaluate whether a transaction has an arm's length result.[149] Therefore, transfer pricing regulations are not required to adhere to strict comparables to meet the arm's length standard in order to satisfy the *State Farm* reasoned decisionmaking standard under the APA.

One possible counterargument may be that the arm's length standard requires adherence to strict comparable transactions because Notice 88-123 (commonly referred to as the "White Paper"), which Treasury issued in 1988, included an endorsement of the arm's length standard as embodied in U.S. tax treaties and major model treaties.[150] The first flaw in this argument is that it contradicts the plain language of § 1.482-1(b). The revised § 1.482-1(b) added a qualification for when to use unrelated party transactions as the basis for the arm's length method. In addition, the revision included a related statement that unrelated party transactions should *generally* be used under comparable circumstances, which makes it clear that the standard need not be *exclusively* reliant on unrelated party transactions.[151] Further, as Professor Reuven S. Avi-Yonah has demonstrated, the legislative history of the 1994 amendment also supports a departure from the strict comparable arm's length approach.[152] The arm's length standard as understood in 1988 was replaced in the United States and elsewhere with a different type of arm's length standard that requires a broader, more flexible method for determining how to allocate profits between related entities.[153] Avi-Yonah suggests that the 1988 White Paper

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147 H.R. REP. NO. 99-426, at 423–26 (1985) (Conf. Rep.) ("Many observers have questioned the effectiveness of the 'arm's length' approach of the regulations under section 482. A recurrent problem is the absence of comparable arm's length transactions between unrelated parties . . . .").

148 *See supra* note 106.

149 *See* discussion of best methods, *supra* Section II.E.

150 I.R.S. Notice 88-123, 1988-2 C.B. 458, 475.

151 Treasury Regulation § 1.482-1(b) was unchanged from 1988 until the 1994 amendment. Before the 1994 amendment, the regulation simply read, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1. 482-1(b) (1988); Treas. Reg. § 1.482-1(b) (1993).

152 *See* Avi-Yonah, *supra* note 25, at 91.

153 *Id.*

itself caused the demise of the traditional[154] arm's length standard.[155] According to this theory, the 1988 White Paper caused this demise by first introducing alternative arm's length methods that departed from reliance on unrelated party transactions.[156] The proposed regulations in 1992, and ultimately the 1994 amended regulation, similarly included alternatives that deviated from reliance on unrelated party transactions, specifically a form of the comparable profits method.[157] Therefore, both the plain meaning of § 1.482-1(b) and its legislative history demonstrate that the arm's length standard does not require adherence to strict comparable transactions.

The conclusion of this Section is helpful to this Note's ultimate conclusion because understanding that Treasury broadened the meaning of arm's length with the 1994 regulations allows Treasury to select *total* employee compensation as the basis for comparison between related and unrelated parties, rather than narrowly focusing on stock-based compensation itself. The following Section proposes that the more flexible arm's length standard, under its current construction, allows Treasury to promulgate new regulations to require related parties that participate in cost-sharing agreements to share at least a portion of stock-based compensation. These proposed new regulations would satisfy *State Farm*'s reasoned decisionmaking standard under the APA by first proposing a response to the comments provided in *Altera*, and then proposing a statement of basis and purpose with adequate reasoning. The proposed response to the comments in *Altera* argues that sharing expenses indexed to stock performance is incomparable between related and unrelated parties due to their different levels of risk,[158] and thus is inappropriate to use as a basis for making an arm's length determination.[159] Next, Treasury can

[154] What Avi-Yonah has referred to as the traditional arm's length standard, I have referred to as the strict comparable arm's length method throughout this Note.

[155] Avi-Yonah, *supra* note 25, at 91.

[156] *Id.* at 135 ("[T]he true message of the White Paper was that the traditional [arm's length standard] could not be applied to the majority of section 482 cases because no comparables could be found. What the White Paper instead achieved was to substitute an *expanded* definition of the [arm's length standard] for the traditional one: [arm's length standard] was now understood to include . . . the rest of the transfer pricing continuum, up to and including profit split, as long as the results reached were compatible with arm's length results.").

[157] Treas. Reg. § 1.482-1T(b)(2)(iii)(C) (as amended in 1994); *see* Avi-Yonah, *supra* note 25, at 144; *supra* Section II.D.

[158] Related companies under common control can use basic management techniques to affect their own stock prices, so they have a level of control over stock compensation expenses that reduces risk to price fluctuations that unrelated companies simply will never have and cannot replace. *See infra* Section III.D.

[159] One commentator suggested that when related parties incur costs that by their nature would not be shared, the arm's length result may have to be hypothesized to determine an arm's length price. Skillman, *supra* note 28, at 351 ("When commonly controlled parties incur costs that by their nature

demonstrate adequate reasoning in a statement of basis and purpose for this regulation if it can provide evidence that related companies share a smaller percentage of *total* employee compensation than unrelated companies in similar arrangements. The basis and purpose of such a regulation would be to eliminate this difference. Eliminating this difference achieves two things: (1) it creates results that are "consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction,"[160] as required by the arm's length standard, and (2) it prevents the "evasion of [income] taxes" as required by the statutory language of I.R.C. § 482.

B. Satisfying the APA

As discussed in Part II, the APA essentially places two separate demands on an agency implementing a legislative rule apart from the administrative requirement of issuing pubic notice.[161] First, the APA requires proportionately detailed responses to comments received from interested persons during the notice-and-comment period.[162] For instance, if a comment criticizes a proposed rule, or the factual predicate for a proposed rule, but the agency retains that characteristic or factual predicate without a relatively detailed response to the criticism, a "reviewing court is likely to hold the rule unlawful."[163] Next, the agency must demonstrate adequate reasoning in their statement of basis and purpose.[164] This adequacy of reasoning statement also encompasses two aspects. First, "[h]ow well has the agency anchored the rule in the [statutory language] it purports to implement?" Second, if the agency's reasoning depends on a pattern of facts existing, "how well has the agency supported its belief in the existence of that pattern of facts?"[165]

Under this standard, the following Section describes how Treasury could reenact legislation that requires sharing stock compensation in cost-sharing agreements that would satisfy the APA and the controlling *State Farm* reasoned decisionmaking standard. First, Treasury would have to

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wouldn't be shared by unrelated parties, there are no truly comparable cost-sharing transactions between unrelated parties," and "in the "absence of unrelated party comparables, the arm's-length standard may have to be applied . . . by hypothesizing the result of that arm's-length dealing.").

160 Treas. Reg. § 1.482-1(b)(1) (2015). This Note proposes that this disparity likely exists given the differing incentives of the two parties in regards to how to compensate employees that participate in cost-sharing agreements. *See* example, *supra* Section I.A.

161 PIERCE, *supra* note 45, at 594.

162 *Id.*

163 *Id.*

164 *Id.*

165 *Id.*

respond to the two major comments received, which contend: (1) there is no evidence of unrelated taxpayers ever sharing stock-based compensation; and (2) stock-based compensation has no economic cost to issuing corporations, so sharing these costs is superfluous. Next, Treasury must adequately reason its statement of basis and purpose to: (1) anchor the rule in the statutory language of § 482 it purports to implement and (2) support its belief in the existence of that pattern of facts with evidence that unrelated companies in cost-sharing agreements disproportionately use stock-based compensation as a percentage of total employee compensation.[166]

C. Responses to Comments

Treasury could provide adequate responses to the comments received as follows. First, although there is no evidence unrelated parties share stock-based compensation, the arm's length standard does not require strict comparable methods.[167] Treasury can pass a regulation that is consistent with the arm's length standard that does not use strict comparables if the transaction is not reasonably comparable. In regards to stock compensation expense, unrelated companies who do not share these expenses are not reasonably comparable to related parties because the two have fundamentally different levels of risk related to these expenses. The two situations have fundamentally different levels of risk because one unrelated company cannot influence the stock price of another unrelated company, but a company can influence their own stock price. This difference turns a portion of the risk profile of stock compensation expense for unrelated parties from an endogenous risk[168] into an exogenous risk—a source of risk that it has no control over because it is completely external to the company.[169] Also, since the same set of interested shareholders control related companies, the internal ability to control stock price and the derivative stock compensation expense remains within the group, and thus is still endogenous rather than exogenous. Similarly, there are two flaws with comments from economists suggesting that stock compensation has no economic effect on issuing corporations. First, stock-based compensation is a deductible tax expense, so at a minimum, this reduction in tax expense

166 *See supra* Section II.B.

167 Treas. Reg. § 1.482-1T(b) (1994); *see supra* Section III.D.

168 Jason Shogren, *Endogenous Risk and Protection Premiums*, 31 THEORY & DECISION 241, 241 (1991) (explaining that endogenous risk arises from sources of risk that result from the companies' own decisions and so the companies have a significant degree of control over them).

169 Ronald E. Shrieves & Drew Dahl, *The Relationship Between Risk and Capital in Commercial Banks*, 16 J. BANKING & FIN. 439, 446–47 (1992).

has that economic effect on the issuing company.[170] Second, Generally Accepted Accounting Principles (GAAP)[171] state that stock compensation expenses have economic effects per the 2006 revised GAAP standards, which require that companies deduct stock compensation expenses as an operating expense similar to any other form of employee compensation.[172] The remainder of this Section will look at each of these proposed responses in greater detail.

Sharing stock-based compensation between related and unrelated parties is not comparable because there are multiple ways that a company can affect its own stock price, but there is no meaningful way for a company to affect the stock price of an unrelated company.[173] First, as an overview, the cost a company must expense or deduct for all stock compensation is directly dependent upon the issuing corporation's stock value for financial statement purposes under GAAP and for income tax purposes of stock-based compensation.[174] Although it can take several iterations, stock-based compensation is often in the form of stock options, which grant the holder the right to buy stock at a future date at a predetermined price, or restricted stock units, which grant an employee the right to a stock or its cash equivalence after the vesting date.[175] One comment that Treasury failed to respond to in *Altera* is an apt characterization of how unrelated parties consider the risk related to sharing another company's stock compensation expense. Comments from American Electronics Association (AeA) and others stated, "unrelated parties would not agree to share or reimburse amounts related to stock-based compensation because the value of stock-based compensation is

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170 N. La Var Harline, *Maximizing Employee After-Tax Wealth for Stock Options and Restricted Stock*, 18 J. DEFERRED COMPENSATION 49, 55 (2013).

171 GAAP is the set of accounting standards the Securities and Exchange Commission requires all publicly traded companies to follow. 17 C.F.R. § 210.4-01 (2016). GAAP is promulgated by an independent, private-sector, non-profit organization called the Financial Accounting Standards Board. FIN. ACCOUNTING STANDARDS BD., ABOUT THE FASB, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 [https://perma.cc/J2RN-WLXZ].

172 FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: SHARE BASED PAYMENT i (2004), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124271&acceptedDisclaimer=true [https://perma.cc/63G3-7NKD] (noting that failing to deduct stock-based compensation as an operating expense "do[es] not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for equity instruments").

173 Shrieves & Dahl, *supra* note 169, at 446–47.

174 Harline, *supra* note 170, at 53, 55–56.

175 *Id.* at 50–55.

speculative, potentially large, and completely outside the control of the parties."[176]

However, for related companies, this risk is much less because one set of stockholders is in ultimate control. Within this group of related companies is substantial endogenous control over the group's stock price through simple management practices. The owners of a company have the ability to appoint managers (which may include themselves) who have the unique ability to affect their own stock price. A company can create shareholder value and thus increase its stock price in the long term through effective management of the corporation.[177] These management techniques focus on making decisions and acquisitions that maximize expected value at the expense of lowering near-term earnings.[178] They also include prudent balance sheet management, returning cash to shareholders in absence of lucrative investment opportunities, rewarding executives for delivering long-term returns, and providing investors with prudent information disclosures.[179] Indeed, academic literature demonstrates well-established findings that periodic corporate earnings directly impact stock returns and stock price of a corporation.[180]

But even more importantly, companies can make a wide range of short-term decisions that can have immediate impact on stock price by massaging earnings reported, known as "earnings management." These earnings management techniques are common because company managers are under tremendous pressure to meet or beat market expectations.[181] In fact, studies demonstrate that due to the importance assigned to meeting earnings expectations, managers become "active players who try to win the game by altering reported earnings."[182] A firm can increase reported earnings by "accelerating the receipt of revenues, deferring expenses or through accounting procedure manipulations."[183] Firms may also make economic decisions that can affect short-term earnings such as instituting

[176] *See* Altera Corp. v. Comm'r, 145 T.C. 91, 101 (2015), *appeal docketed*, No. 16-70497 (9th Cir. Feb. 23, 2016).

[177] Alfred Rappaport, *10 Ways to Create Shareholder Value*, HARV. BUS. REV., Sept. 2006, at 68.

[178] *Id.* at 69.

[179] *Id.* at 71–76.

[180] Eli Bartov et al., *The Rewards to Meeting or Beating Earning Expectations*, 33 J. ACCT. & ECON. 173, 174 (2002) (stating this well-established finding was first documented in 1968).

[181] *Id*. at 173 (stating meeting or beating analysts' market forecasts is well-entrenched in corporate culture).

[182] *Id*.

[183] Merle Erickson & Shiing-wu Wang, *Earnings Management by Acquiring Firms in Stock for Stock Mergers*, 27 J. ACCT. & ECON. 149, 150 (1999).

layoffs, selling assets,[184] engaging in stock repurchases,[185] offering short-term price discounts, overproducing goods to reduce cost of goods sold, and aggressively reducing discretionary spending such as R&D.[186] In fact, empirical studies demonstrate that before a stock-for-stock merger, companies manage earnings upward to reduce the amount of stock an acquisition requires.[187] In addition, empirical studies demonstrate that companies also manage earnings downward to reduce stock price in anticipation of large stock-option grants to CEOs in order to increase their own personal return.[188] As a result, it is clear that companies can endogenously exert tremendous influence over their own stock prices. This ability is completely nonexistent for unrelated parties because companies do not have any control over the management of an unrelated company and thus cannot implement any of the techniques cited. Not only that, but the fact a company controls its own stock price introduces a new risk for an unrelated party in a potential cost-sharing agreement. This in itself is a new major source of exogenous risk because either unrelated party could at any moment undertake any one of the multiple ways companies manage short-term earnings, which would directly affect the amount of stock compensation expense the other party is liable for.

Finally, companies can control the expense and volatility of stock compensation by setting the terms of their options or stock grants. The most important terms that a company decides relate to vesting and maturity which determine the volatility of option expenses.[189] Vesting determines when an employee can exercise an option, and maturity describes when an option expires.[190] One could imagine a company awarding options with an immediate vesting date and one-day maturity that offers little to none of the potential expense volatility referenced by AeA in *Altera*.[191] A potential

184 *Id.* at 150.

185 Paul Hribar et al., *Stock Repurchases as an Earnings Management Device*, 41 J. ACCT. & ECON. 3, 4 (2006) (stating their study demonstrates that some firms use repurchases to compensate for earnings shortfalls).

186 Sugata Roychowdhury, *Earnings Management Through Real Activities Manipulation*, 42 J. ACCT. & ECON. 335, 336 (2006) (stating companies manage earnings by adjusting operational activities in ways that deviate from normal business practices; specifically, that companies "avoid[] losses by offering price discounts to temporarily increase sales, engage in overproduction to lower cost of goods sold, and reduce discretionary expenditures aggressively to improve margins").

187 *Id.* at 174.

188 Mary Lea McAnally et al., *Executive Stock Options, Missed Earnings Targets, and Earnings Management*, 83 ACCT. REV. 185, 212 (2008).

189 Pamela Brandes et al., *Effective Employee Stock Option Design: Reconciling Stakeholder, Strategic, and Motivational Factors*, 17 ACAD. MGMT. EXECUTIVE 77, 86 (2003).

190 *Id.*

191 *See supra* text accompanying note 176.

counterargument is that for a grant with that small of a vesting and maturity window to have value, it would most likely need to be granted with a per-share exercise price less than fair market value and would thus be subject to penalty tax under § 409A of the I.R.C.[192] Although this is true, a company can circumvent potential § 409A penalties if a company issues restricted stock or restricted stock units rather than stock options.[193] Therefore, it is clear that related companies can endogenously manage the relative risk and volatility of stock option expense by managing the types and terms awarded, while an unrelated company would be unable to manage such stock option risk of an unrelated company.

Critics may argue unrelated companies would not always have additional stock option expense risk because they could contractually agree not to manage earnings or the terms of the stock compensation such as terms, exercise price, etc. However, just because companies could go through additional steps to mitigate these risks does not establish that the instances are comparable. First, because companies would have to negotiate these additional terms, an inevitable difference between related and unrelated companies is that unrelated companies would have to give up a degree of flexibility. For example, as discussed, there are a multitude of short-term economic decisions for managing a company's stock price such as instituting layoffs, selling assets, engaging in stock repurchases, offering short-term price discounts, overproducing goods to reduce cost of goods sold, and aggressively reducing discretionary spending such as R&D. The need to make a change in any one of these areas often has legitimate business reasons, and a company would not want to lose this ability. Finally, even if companies were agreeable to such contract terms, at a minimum they would include high monitoring costs to ensure the other party was compliant with the agreement and are arguably undesirable for that reason alone. Therefore, unrelated companies could not simply contract around the differences between unrelated and related companies sharing stock compensation expenses.

Another potential counterargument could be made that related companies do not enjoy the same ability to influence stock price in the manner a company can influence its own stock price because the companies are separate entities with separate boards of directors that can

[192] *Section 409A Creates Important Stock Option Issues*, TAX DEP'T: BENEFITS & COMP. UPDATE (Latham & Watkins), Jan. 2005, https://www.lw.com/upload/pubcontent/_pdf/pub1161_1.pdf [https://perma.cc/L4HL-2SY2].

[193] *Stock Rights Under Final Section 409A Regulations*, WSGR ALERT (Wilson Sonsini Goodrich & Rosati), Apr. 19, 2007, https://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/pdfsearch/clientalert_409astockrights.htm [https://perma.cc/YP9U-GGAZ].

appoint separate management teams. Indeed, it is possible some related companies truly separate management, and the parent company does not dominate the management of the subsidiary. However, the subsidiary management can always affect the stock price of a parent company by affecting its own value, which is a component of the parent company's total value. Furthermore, there is nothing besides the threat of piercing the corporate veil to prevent a parent company from dominating the management of a subsidiary, and thus there is vast potential for abuse. Such abuse stems from the fact that the board of directors of the parent company has the right to appoint the board of directors of the subsidiary, and nothing prevents it from appointing its own members. Therefore, even if some related parties cannot influence the stock price of the parent company, there remains the potential that the same individuals manage these companies, and at a minimum, they are still controlled by the same shareholders.

Finally, the other comment provided by AeA—arguing that stock-based compensation has no economic effect on issuing corporations—has two major flaws. First, stock-based compensation is a deductible tax expense, so at a minimum, this reduction in tax expense must have some economic effect on the issuing company.[194] Second, GAAP states that stock compensation expense has economic effect per the 2006 revised GAAP standards, which require companies to deduct stock-based compensation as an operating expense similar to any other form of employee compensation.[195] Thus, the tax benefit at a minimum creates an economic impact to the company allowed to take the deduction, and additionally, GAAP clearly states these expenses have economic impact similar to other compensation expenses.[196] For the reasons stated above, these responses, if made by Treasury to the major comments, could have satisfied the second prong of the APA requirements.

D. Statement of Basis and Purpose

In addition to responding to comments, Treasury must also adequately reason the basis and purpose for such a legislative rule.[197] As such, Treasury must: (1) anchor the rule in the statutory language of § 482 and (2) support its belief that a pattern of facts exists to justify the rule.[198] Since

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[194] Harline, *supra* note 170, at 55.

[195] *See supra* note 172.

[196] *See supra* note 172. Warren Buffett also clearly agrees that stock-based compensation is an expense with an economic impact. *See supra* note 10.

[197] PIERCE, *supra* note 45, at 594.

[198] *Id.*

the rule is promulgated under I.R.C. § 482,[199] the purpose of the regulation should be anchored in the statutory language "clearly to reflect . . . income" and to "prevent [the] evasion of income taxes."[200] Additionally, the regulation must satisfy the arm's length standard under § 1.482-1(b), as all transfer pricing regulations are currently bound by this overarching definition.[201]

As discussed previously, the arm's length standard does not strictly require using comparable transactions.[202] However, the standard does require the "results of [a] transaction" to be "consistent with the results that would have been realized if uncontrolled [unrelated] taxpayers had engaged in the same transaction."[203] Although uncontrolled taxpayers do not share stock compensation expense, it is possible the results of related party transactions are inconsistent with unrelated parties if related parties use stock-based compensation as a greater proportion of total employee compensation.

Next, Treasury would have to anchor the proposed rule in the statutory language of § 482. To do so, the economic reality for related parties in cost-sharing agreements must be considered. For related parties, every dollar of employee compensation in the form of stock-based compensation that replaces other forms of employee compensation provides a fantastic tax benefit. The company gets a deduction for the stock compensation, which reduces its taxable income, and it is not required to receive a payment from its foreign subsidiary, which also reduces its taxable

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[199] See Jasper L. Cummings, Jr., *Holding Treasury to Its Word:* Altera *and Capricious Regulations*, 149 TAX NOTES 519, 522 (2015), for a discussion of how the second sentence of § 482, the "commensurate with income standard," could arguably support requiring related parties to share stock compensation expenses. *Id.* (arguing respondent should have better developed an alternate argument "based on the commensurate with income standard"). This Note alternatively argues that the first sentence of § 482 provides all the support necessary when using the broadened arm's length standard under the 1994 regulations. This argument is preferred because satisfying the arm's length standard would likely be required under Cummings' approach as well, because the Treasury has "longstanding authoritative interpretation set forth in the regulations and other published guidance . . . that the commensurate with income standard must be applied consistently with the arm's length standard." I.R.S. Chief Couns. Mem. AM-2007-007, at 1 (Mar. 23, 2007).

[200] I.R.C. § 482 (2012); *see also* Treas. Reg. § 1.482-1(a) (2015) ("The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.").

[201] Cummings, *supra* note 199, at 522 (stating that the clear reflection of an income standard "has long been interpreted to require controlled parties to deal as would unrelated persons dealing at arm's length" (citing Comm'r v. First Sec. Bank of Utah, N.A., 405 U.S. 394 (1972))); *see also* Avi-Yonah, *supra* note 25, at 97 (tracing the arm's length standard to the "true net income" standard discussed in the 1935 regulations).

[202] *See supra* Section III.A.

[203] § 1.482-1(b).

income.[204] Thus, a bright-line rule to exclude sharing stock compensation from cost-sharing agreements likely encourages related parties to substitute stock compensation for other forms of compensation. If Treasury can demonstrate that related companies in cost-sharing agreements pay a greater percentage of total employee compensation as stock-based compensation, it can establish that the results are not arm's length, because they are not "consistent with the results that would have been realized if uncontrolled [unrelated] taxpayers had engaged in the same transaction."[205] Treasury would argue that sharing these expenses is required to achieve the purpose of § 482, in order to prevent the evasion of income taxes by clearly reflecting the income of the taxpayer and produce an arm's length result.[206] This argument likely principally satisfies the reasoned decisionmaking standard under the APA to anchor the rule in the statutory language of § 482.

In addition, Treasury would also have to support its belief that a pattern of facts exists to justify the new regulation. The evidence needed by Treasury to support its belief would likely be easy to produce. Treasury would just have to identify and categorize two groups that participate in cost-sharing agreements, related and unrelated companies. Treasury then would compute the average percent of total employee compensation unrelated companies pay by salary versus the average percent of total employee compensation related companies pay by salary. As described above, it is probable that related companies pay employees who participate in cost-sharing agreements with a greater percentage of stock compensation due to the one-sided accounting for the transaction, i.e., a U.S. company recognizes a deduction without having to recognize any related income while the foreign subsidiary's ownership percentage in the asset is unchanged. Evidence that related companies are using stock-compensation as a greater percentage of total employee compensation would demonstrate that related companies are sharing less total employee compensation than unrelated companies.

For example, on average unrelated parties in cost-sharing agreements may spend \$100,000 in total employee compensation, wherein \$95,000 is salary and \$5,000 is stock compensation, and thus share 95% of total employee compensation. On the other hand, related companies may spend \$100,000 in total employee compensation, but \$50,000 is salary and \$50,000 is stock compensation, and thus only share 50% of total employee

[204] *See supra* Section I.A.
[205] § 1.482-1(b).
[206] I.R.C. § 482 (2012); *see* Treas. Reg. § 1.482-1(a).

compensation. Because related companies in this example pay employees with 45% more stock compensation, they are sharing 45% less total employee compensation than unrelated companies.

One could argue that it would be inappropriate to compare the percentage of employee compensation paid by salary between related and unrelated companies because the same difference this Note highlighted previously makes the two unreasonably comparable. However, the unreasonable comparison is limited only to stock compensation. That same fundamental difference does not apply to whether the percentage of total employee compensation paid as salary is comparable. The amount of salary paid by controlled and uncontrolled parties has the exact same level of risk, and therefore it is an appropriate dimension to compare.

Another argument could likely be made that Treasury could never meet the reasoned decisionmaking standard because the Court already ruled in *Xilinx*, based on the 1994 regulations, that sharing stock compensation does not meet the basic arm's length standard in § 1.482-1(b). However, this argument has two flaws. First, in *Xilinx*, the government never argued that the evidence offered—that uncontrolled taxpayers had never shared stock compensation—was not sufficiently comparable to be used as the basis to determine an arm's length result.[207]

Second, a court's analysis of whether an agency exercised reasoned decisionmaking involves a higher level of deference than the court's determination of whether the Commissioner's adjustment was reasonable.[208] Under the *State Farm* standard, courts only invalidate a rule for being arbitrary or capricious. This standard is defined as follows:

> [A]n agency rule would be arbitrary and capricious if the agency has [1] relied on factors which Congress has not intended it to consider, [2] entirely failed to consider an important aspect of the problem, [3] offered an explanation for its decision that runs counter to the evidence before the agency, or [4] is so

[207] *See* Memorandum Brief in Support of Respondent's Notice of Objection to Petitioner's Supplement to Partial Summary Judgment Motion with Respect to the Stock Option Issue at 85–86, *Xilinx I*, 125 T.C. 37 (2005) (No. 4142-01), 2002 WL 34234097, at *85–86.

[208] *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1965), defines the standard of review for transfer pricing adjustments as allowing the court to review for adjustments that are "unreasonable, arbitrary or capricious." Facially this may not seem to be a lower burden, but as commentators have described, in practice, courts assign a much lower standard. *See* LOWELL & BRIGER, *supra* note 5, ¶ 3.14[2], 1999 WL 257449 (2016) ("[T]his burden has been carried in a sufficiently frequent manner to suggest that the reality is not as daunting for the taxpayer as the mere statement of the standards would indicate.").

implausible that it could not be ascribed to a difference in view or the product of agency expertise.[209]

The first two instances would not apply to the issue at hand. Congress has intended for Treasury to consider whether certain transfer pricing practices serve as a basis for a taxpayer to avoid income taxes, such as substituting salary expense for stock-based compensation in order to reduce payments from their foreign subsidiary. Furthermore, in *Altera* there was no implication that Treasury did not consider an aspect of the problem. The third instance may apply, but is easily dismissible. After establishing that related parties sharing (or not sharing) stock compensation is not comparable because of the vastly different risk between related and unrelated parties, the evidence provided would no longer be relevant.[210] In addition, in order for Treasury to reenact such a rule, this Note assumes that they will be able to provide evidence[211] that controlled parties provide a lower percentage of total employee compensation as salary expense vis-à-vis uncontrolled parties. This evidence would support Treasury's position that requiring uncontrolled parties to share stock compensation costs is consistent with an arm's length result.[212] Finally, the fourth instance similarly is dismissible. If Treasury can demonstrate that unrelated parties compensate their employees using a greater rate of stock compensation than unrelated parties, requiring related companies to share these costs is at minimum a difference in view. Therefore, even though the court held in *Xilinx* that sharing stock compensation costs is inconsistent with the arm's length standard, it is by no means certain that a future court would strike down as arbitrary or capricious a regulation requiring at least a portion of these expenses to be shared.

Therefore, Treasury has the ability to reenact a stock compensation sharing regulation under the existing definition of the arm's length standard. First, the arm's length standard does not require a strict comparable method when appropriate comparables do not exist. Next, sharing stock-based compensation is not comparable between related and unrelated parties because there is a fundamental difference between the significant control a related group exercises over its stock price and the lack of control over an unrelated company's stock price. Finally, if

[209] Motor Vehicle Mfrs. Assn. of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

[210] *See supra* Section III.C.

[211] If there is no evidence that related parties are compensating employees using stock-based compensation at a greater rate than unrelated parties, then there is no evasion of income tax, and therefore enacting a similar rule would not have any reasonable basis.

[212] *See supra* Section III.A.

Treasury can demonstrate that controlled taxpayers have paid a lower percentage of total employee compensation as salary than uncontrolled taxpayers, they can show such a rule is necessary for the results of related party transactions to be consistent with the results unrelated parties would reach as required by the arm's length standard.

CONCLUSION

In *Altera Corp. v. Commissioner*, the U.S. Tax Court invalidated a 2003 Treasury regulation on APA grounds for failing to meet *State Farm*'s reasoned decisionmaking standard.[213] The Tax Court's decision marked the third consecutive failed attempt by the U.S. government to require foreign subsidiaries that are parties of "cost-sharing agreements" to reimburse a U.S. parent company for stock compensation expenses.[214] This Note fills the gap left by the *Altera* decision and remedies Treasury's repeated failures by providing an argument that would satisfy *State Farm*'s reasoned decisionmaking standard under the APA. This Note demonstrates that contrary to what other commentators have suggested,[215] the existing definition of the arm's length standard requires reference only to unrelated parties when the circumstances are sufficiently comparable. This Note further establishes the fact that unrelated parties have not shared these expenses in the past is irrelevant because there are fundamentally different levels of risks for unrelated and related parties in sharing stock compensation expense. Treasury can satisfy *State Farm*'s reasoned decisionmaking standard if Treasury can provide empirical evidence that unrelated parties use stock compensation at a greater rate than related parties. This evidence would satisfy *State Farm*'s reasoned decisionmaking standard because it would demonstrate the regulation is necessary to prevent taxpayers from evading income tax, and thus achieve the purpose of § 482. In sum, reviving this regulation closes one corporate tax loophole left by *Altera*, and allows the IRS to appropriately tax extremely profitable high-tech companies, such as Apple and Google, that engage in these types of cost-sharing agreements.[216]

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[213] 145 T.C. 91, 132 (2015), *appeal docketed*, No. 16-70497 (9th Cir. Feb. 23, 2016). All voting Tax Court judges signed on to the opinion and thus the Tax Court was unanimous. *See* Gupta, *supra* note 9, at 134.

[214] *See* Gupta, *supra* note 9, at 4.

[215] *See id.* at 2 (claiming the arm's length standard is "statutorily enshrined," although arm's length is not mentioned in the statutory Internal Revenue Code).

[216] *See supra* Part I.