AUGUST 2015
www.bdo.com

AN ALERT FROM THE BDO TRANSFER PRICING PRACTICE

BDO KNOWS: TRANSFER PRICING

SUBJECT

THE TAX COURT STRIKES DOWN COST-SHARING REGULATIONS' REQUIREMENT TO SHARE STOCK-BASED COMPENSATION COSTS

SUMMARY

In a partial summary judgment decision rendered on July 27, 2015, the United States Tax Court ("Tax Court") struck down the 2003 amendment to the Internal Revenue Code ("IRC") § 482 cost sharing regulations that require controlled entities entering into qualified cost-sharing agreements ("QCSAs") to share stock-based compensation costs. The decision, which was reviewed by the Tax Court, validates Altera Corporation's ("Altera-US") position in ***Altera Corp. v. Commissioner*** that the final regulations ("T.D. 9088") violate the arm's-length standard due to a lack of evidence that unrelated parties ever share such costs.[1]

DETAILS

On October 20, 2003, the Internal Revenue Service ("Service") published final regulations, T.D. 9088, which provided guidance on the treatment of stock-based compensation for the purpose of updating, clarifying, and improving regulatory guidance in the area of transfer pricing and the rules governing QCSA's. On the topic of cost-sharing, these regulations prescribed rules for measuring the costs associated with stock-based compensation. T.D. 9088 was intended to align the rules of Treasury Regulation ("Treas. Reg.") § 1.482-7, regarding QCSAs, with the commensurate-with-income standard and the arm's-length standard to the extent that the participants' shares of income reasonably reflected the actual economic activity undertaken by each.

[1] Altera Corporation v. Commissioner, 145 T.C. No. 3 (July 27, 2015).

CONTACT:

ROBERT PEDERSEN, International Tax Partner
(212) 885-8398 / rpedersen@bdo.com

ROBERT M. BROWN, Partner
(412) 281-6018 / rmbrown@bdo.com

SCOTT HENDON, Partner
(214) 665-0750 / shendon@bdo.com

MONIKA LOVING, Partner
(404) 979-7188 / mloving@bdo.com

BRAD RODE, Partner
(312) 233-1869 / brode@bdo.com

WILLIAM F. ROTH III, Partner
(616) 776-3761 / wfroth@bdo.com

JERRY SEADE, Principal
(713) 986-3108 / jseade@bdo.com

JOE CALIANNO, Partner and International Technical Tax Practice Leader
(202) 904-2402 / jcalianno@bdo.com

VEENA PARRIKAR, Principal, Transfer Pricing
(408) 352-3534 / vparrikar@bdo.com

KIRK HESSER, Sr. Director, Transfer Pricing
(312) 233-1802 / khesser@bdo.com

MICHIKO HAMADA, Sr. Director, Transfer Pricing
(212) 885-8577 / mhamada@bdo.com

In 2005, the Tax Court rejected the Service's treatment of employee stock options under the taxpayer's cost-sharing arrangement with its subsidiaries in ***Xilinx Inc. et al. v. Commissioner***.[2] The Tax Court determined that the regulations applicable at the time did not allow the Service to require taxpayers to share the spread or grant date value relating to employee stock options under the cost-sharing agreement. The Ninth Circuit supported the Tax Court's decision that controlled entities entering into QCSAs were not required to share stock-based compensation costs because parties operating at arm's-length would not do so. [3]

CASE DETAILS

Altera-US, a Delaware corporation, develops, manufactures, markets, and sells programmable logic devices ("PLDs") and related hardware and software. Altera-US is the parent company of Altera International, Inc. ("Altera-Cayman"), a subsidiary located in the Cayman Islands. As part of a QCSA, Altera-US and Altera-Cayman entered into two agreements: (i) a master technology license agreement ("Technology License Agreement") and (ii) a technology research and development cost-sharing agreement ("R&D-CSA"). The Technology License Agreement granted Altera-Cayman the right to license pre-existing intellectual property ("IP") from Altera-US and allowed for the use and exploitation of this IP associated with the sale of PLDs outside of the U.S. and Canada. Altera-Cayman paid royalties to Altera-US for the right to use this IP every year from 1997 to 2003. After 2003, Altera-Cayman made the requisite payment to obtain a fully paid-up license to use the pre-existing IP in its territory.

Under the R&D-CSA, Altera-US and Altera-Cayman agreed to combine their respective research and development ("R&D") resources to further enhance the pre-existing IP and share in the costs and risks of the R&D activities conducted after May 23, 1997. During the tax years 2004 through 2007, Altera-US granted stock-based compensation to its employees and did not share these costs with Altera-Cayman. On audit, the Service determined deficiencies in the calculation of the cost base to be shared by Altera-US and Altera-Cayman and made allocations pursuant to Treas. Reg. § 1.482-7(d)(2). The taxpayer and the Service filed cross-motions for partial summary judgment.

The case consolidates two separate deficiency notices and involves $80 million in adjustments to income for years 2004-2007 related to the grant of stock-based compensation by Altera-US. The Service, at an oral argument, contended that IRC § 482 doesn't require income to be allocated based solely on evidence of uncontrolled-party transactions, but rather on whether a transaction is priced at arm's-length, and that such an evaluation could be made in any number of ways. The Service maintained that T.D. 9088 regulations are governed by the commensurate-with-income standard of IRC § 482 and by requiring that stock-based compensation be shared among related parties, an "arm's-length result" may be reached. The Service asserted that unrelated parties entering into QCSAs to develop high-profit intangibles would share the costs of stock-based compensation if stock-based compensation was a significant element of compensation. Altera-US contended that many QCSAs do not pertain to high-profit intangibles and that stock-based compensation is not a significant element of the compensation of taxpayers that enter into QCSAs.

The Tax Court found that the final rule lacked factual basis because the Service failed to provide adequate evidence. The Tax Court first noted that in its ruling of ***Xilinx*** the court, "…concluded that Congress never intended for the commensurate-with-income standard to supplant the arm's length standard." [4] The Service failed to support its claims with any administrative record that showed unrelated parties would share stock-based compensation costs. The Service's files associated with the final ruling did not contain any expert opinions, empirical data, published or unpublished articles, papers, surveys, or reports supporting the determination that stock-based compensation must be included in QCSAs to achieve an arm's-length result. The Service also failed to produce any agreements between unrelated parties in which one party reimbursed the other parties for amounts attributable to stock-based compensation.

The Service did not dispute either of Altera-US's claims that many QCSAs are not associated with high-profit intangibles and that stock-based compensation is an insignificant element of the compensation of taxpayers that enter into QCSAs. Furthermore, the Service never claimed that it found any of the evidence submitted by commentators as invalid, implicitly accepting the commentators' economic analyses, which argued against the sharing of stock-based compensation by unrelated parties.

---

[2] Xilinx Inc. et al. v. Commissioner, 125 T.C. 37 (2005).
[3] Xilinx v. Commissioner, 567 F.3d 482 (9th Cir. 2009); rev'g and remanding 125 T.C. 37, withdrawn, 592 .3d 1017 (9th Cir. 2010)
[4] Xilinx Inc. et al. v. Commissioner, 125 T.C. 37 (2005).

BDO INSIGHTS

- Taxpayers should monitor the developments of this case and consider whether there is a position to file amended tax returns, especially for periods that may be closing due to the expiration of the statute of limitations. This decision may have significant implications with respect to the treatment of these, and other similar, costs going into the current and future tax years.
- The Service's unsuccessful attempt to argue that the commensurate-with-income approach will, essentially, result in an arm's-length arrangement indicates that empirical evidence will be essential for any regulatory implementation of the arm's-length standard. The decision may also result in implications that go beyond the United States cost-sharing regulations, such as the Organization for Economic Cooperation and Development's ("OECD") proposals to combat base erosion and profit shifting ("BEPS").