

US Supreme Court declines review of Altera Ninth Circuit decision, upholding IRS's stock-based compensation regulation

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In brief

The US Supreme Court on June 22, denied Altera's petition for writ of certiorari in *Altera Corp. v. Commissioner* (#19-1009). The decision means that the Supreme Court will not review the Ninth Circuit's June 7, 2019 decision upholding the validity of Treas. Reg. sec. 1.482-7A(d)(2), which required stock-based compensation (SBC) costs to be included in the pool of intangible development costs (IDCs) under a cost sharing arrangement (CSA).

The Supreme Court's denial of Altera's petition could have significant tax and financial reporting consequences for companies that have excluded SBC costs from CSA IDC pools. While the Ninth Circuit's decision regarding the validity of Treas. Reg. sec. 1.482-7A(d)(2) is controlling precedent in the Ninth Circuit, the regulation's validity remains open to challenge in other circuits.

In detail

Background

Factual background

Altera Corporation (Altera) is a US taxpayer that entered into a research and development cost sharing agreement (R&D CSA) with a foreign subsidiary. For tax years 2004 through 2007, Altera granted stock options and other SBC to certain employees, but did not include any SBC expenses in the pool of costs shared under the R&D CSA.

The IRS asserted that Altera's failure to share SBC costs violated Treas. Reg. sec. 1.482-7A(d)(2), a regulatory provision published in 2003 requiring that SBC costs be included in the costs shared under a CSA (the SBC rule). Treas. Reg. sec. 1.482-7A(d)(2) is substantially similar to Treas. Reg. sec. 1.482-7(d)(3), the regulation currently in effect that requires taxpayers to include SBC costs as IDCs under a CSA.

Procedural background

On July 27, 2015, the US Tax Court in *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), held that the SBC rule was invalid. In a unanimous 15-0 decision, the Tax Court held that Treasury and the IRS failed to provide a reasoned basis for the SBC rule that was consistent with the arm's-length standard. For a summary of the Tax Court's decision, see the [PwC Tax Insight issued August 6, 2015](#).

On June 7, 2019, a Ninth Circuit panel issued a 2-1 decision that determined that the disputed SBC rule was valid both procedurally and substantively. For details regarding the Ninth Circuit's June 2019 opinion and subsequent denial of a rehearing en banc, please see the [PwC Tax Insight dated June 17, 2019](#) and the [PwC Tax Insight dated November 21, 2019](#).

On February 10, 2020, Altera petitioned the US Supreme Court for writ of certiorari. Altera's petition was supported by numerous amicus briefs urging the Court to hear the case due to the important implications relating to the meaning of the arm's-length standard under Section 482 and administrative law more generally.

On June 22, 2020, the US Supreme Court denied Altera's petition ([#19-1009](#)). The Supreme Court did not comment on why the petition was denied. The Supreme Court's denial marks the final point of appeal in *Altera Corp. v. Commissioner*. **Observation:** The Supreme Court's denial of certiorari should not be understood as an implicit endorsement of the Ninth Circuit's opinion in *Altera* or the Government's position regarding the validity of Treas. Reg. sec. 1.482-7A(d)(2).

Possible judicial review in other circuits

The validity of Treas. Reg. sec. 1.482-7A(d)(2) has long been a source of disagreements among practitioners, academics, and judges. While the Supreme Court's denial of Altera's petition leaves intact the Ninth Circuit's decision in *Altera Corp. v. Commissioner*, it can be expected that the Tax Court would continue to follow its 15-0 decision in *Altera* in future cases involving taxpayers outside the Ninth Circuit. Similarly, other federal courts outside the Ninth Circuit could choose to invalidate Treas. Reg. sec. 1.482-7A(d)(2) under a rationale like the Tax Court's. Accordingly, it is possible that other taxpayers may choose to pursue litigation regarding the validity of the SBC rule in their own cases.

While the IRS has repeatedly asserted that SBC costs must be included in the pool of shared IDCs under a CSA, the Tax Court's unanimous opinion, coupled with the dissenting views of some Ninth Circuit judges, demonstrates that the issue is far from a final determination.

Observation: The US Supreme Court's denial of certiorari is not a definitive resolution of the issue regarding the validity of Treas. Reg. sec. 1.482-7A(d)(2). Given the materiality of the decision, and the enormous impact on businesses, the SBC rule could be litigated in another circuit. A possible circuit split, which could lead the Supreme Court to grant a writ of certiorari in the future, may not emerge for several years. Thus, while the validity of the SBC rule ultimately may still be decided by the Supreme Court, such a resolution could be years away.

Implications for CSAs and financial statement accounting

The Supreme Court's denial of Altera's petition for writ of certiorari makes the Ninth's Circuit June 2019 decision binding precedent in the Ninth Circuit, although the opinion may carry persuasive weight with courts outside the Ninth Circuit as well. Many taxpayers have adopted contractual provisions in their CSAs referring specifically to SBC and the validity of the regulatory SBC rule. Taxpayers with such contractual provisions — especially those that specifically reference the *Altera* case — should consider the impact of the Supreme Court's action on their contractual obligations and the associated tax consequences.

Observation: In addition, taxpayers should consider whether the Supreme Court's action affects the prior conclusions of company management regarding the appropriate financial accounting treatment of tax benefits attributable to the exclusion of SBC costs from IDC pools. The impact on financial statement accounting may be relevant for taxpayers both within and outside the Ninth Circuit.

Observation: With the Ninth Circuit's *Altera* decision intact, taxpayers can expect the IRS to diligently pursue examinations of the SBC cost issue and proceed with corresponding adjustments.

Implications for application of the arm's-length standard

The continued vitality of the Ninth Circuit's decision in *Altera* could have implications beyond the narrow question of whether SBC costs must be shared under a CSA.

The Ninth Circuit's majority opinion states that Section 482 is 'flexible' and 'fluid,' and suggests that in some circumstances empirical analysis may have limited or no significance. This approach of the Ninth Circuit was rooted primarily in decades-old case law that predated the robust Section 482 regulatory framework that was initially promulgated in 1968 and that since has been significantly expanded. The governing Section 482 regulations repeatedly reference uncontrolled transaction results as the touchstone for evaluation of a taxpayer's compliance with the arm's-length standard. Nevertheless, the Ninth Circuit, relying on the Commensurate With Income (CWI) standard of Section 482, concluded that 'internal allocation methods' without reference to uncontrolled transactions are 'reasonable methods' for purposes of Section 482.

Observation: The absence of a Supreme Court opinion in *Altera* leaves uncertainty and confusion regarding the application of the arm's-length standard. The Ninth Circuit's interpretation of Section 482 raises serious questions regarding consistency with the Section 482 regulations and other Section 482 jurisprudence. Broader application of the Ninth Circuit's interpretation of the arm's-length standard could result in protracted disputes between taxpayers and the IRS relating to the fundamental meaning of that standard, in addition to the particular manner in which a taxpayer has applied it. This is particularly true if Treasury and the IRS, in light of the Supreme Court's denial of certiorari in *Altera* and the Ninth Circuit's approach, seek to adopt positions under Section 482 that are not rooted in empirical evidence of uncontrolled transaction results. Similarly, a tax authority's adoption of an interpretation of the arm's-length standard similar to the Ninth Circuit's could increase the risk of double taxation for multinational enterprises due to the potential for different jurisdictions to adopt drastically different analytical approaches with respect to the same transaction.

The takeaway

The Supreme Court will not review the Ninth Circuit's June 7, 2019 decision upholding the validity of Treasury Reg. sec. 1.482-7A(d)(2), requiring SBC costs to be included in the costs shared in a CSA. Although the *Altera* issue is now resolved in the Ninth Circuit, the Ninth Circuit's opinion is not binding in other circuits (although it still could be considered persuasive authority).

While the Ninth Circuit's decision is now binding precedent in that court, other circuits ultimately could agree with the Tax Court's decision holding Treasury Reg. sec. 1.482-7A(d)(2) to be invalid. Thus, the final resolution of the issue in the Ninth Circuit does not preclude the litigation of this issue in other circuits.

Taxpayers that participate in CSAs and incur SBC costs should consider whether the Supreme Court's denial of review affects their contractual obligations with respect to SBC costs and their accounting for the tax impact of the SBC issue in their financial statements. Taxpayers also should be prepared for the IRS to diligently pursue examination adjustments on the SBC issue.

Finally, the Ninth Circuit's *Altera* opinion reflects a more flexible and fluid interpretation of Section 482 than previously understood and could lead the IRS and the Treasury to take more expansive views of their Section 482 authority.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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