Tax Court: Stock-Based Compensation Costs Need not be Included in International Cost-Sharing Arrangements

The Stunning Altera *Case*

By James P. Klein, William E. Bonano and Susan P. Serota

Employee stock options are an important part of compensation—both as income to the executives and as a deduction for the employer. But when stock options are used by multinational companies, the tax implications are complex and sometimes baffling. A new Tax Court case has just given the IRS a stunning defeat by holding the 2003 Treasury Regulations under Internal Revenue Code Section 482 invalid as not reflecting reasoned decision making and being contrary to real-life evidence. The result is a taxpayer victory permitting, in effect, full deduction of stock-based compensation costs under a cost sharing arrangement. As a consequence, multinational employers with equity-based compensation may have reduced U.S. taxes based on not having to include such costs in the pool of costs to be shared under a cost sharing arrangement. Such arrangements are commonly used to allow affiliates in tax-favored jurisdictions to acquire tax ownership of territorial IP exploitation rights, resulting generally in decreasing the multinational's overall effective tax rate.

Basic Issue of Allocation of Income and Deductions

The basic U.S. tax rule relating to stock-based compensation is that the employer gets a tax deduction in the same amount and in the same tax year as the compensation income is recognized by its employees when non-qualified stock options are exercised. If the employer has operations outside the U.S., an employee may not be fully taxable on this income (for example, for aliens employed inside and outside the U.S.); but the employer still gets a full deduction for its employees' stock-based compensation.

That basic rule was altered by the Internal Revenue Service's (IRS) rules on qualified cost sharing arrangements. This complicated area is based on the principle that under the Internal Revenue Code Section 482, related companies must allocate certain costs and income consistent with an arms-length standard, i.e. shared among the related companies consistent with how unrelated parties would have shared such costs and income. There are lengthy regulations issued under Section 482, but the treatment of the "cost" of compensation based on stock-based compensation under the regulations has been an area of controversy for many years.

Historic Taxpayer View

The regulations under section 482 have long permitted U.S. taxpayers to share the costs of developing intangible property, e.g. intellectual property, including the cost of compensation of employees working on the development, with affiliated companies. For example, a U.S. company might enter into a cost sharing arrangement with an offshore subsidiary located in a low tax rate or tax haven country, granting that subsidiary exploitation rights as to any resulting products or technology in a specified territory outside of the U.S. Section 482 and its implementing regulations provide the rules as to which (and the amount of) costs must be allocated to the subsidiary under such an arrangement. There has never been an argument about direct compensation costs of the employees *of the U.S. parent* who work on the project. The argument has been whether the compensation must include stock-based compensation such as the "spread" between a stock option strike price and the price of the underlying shares.

The basic rule under section 482 is that cost allocation should be comparable to that found in arm's-length transactions. For the IRS, this meant that *all* compensation costs should be allocated, including compensation from stock options. U.S. taxpayers, however, argued that unrelated parties in an arm's-length agreement would not share these costs. The IRS litigated and lost on its position (*Xilinx*, 598 F.3d 1191 (9th Cir. 2010)) based on 1995 Treasury regulations. The IRS and Treasury amended the regulations in 2003 to make the stock-compensation costs specifically included. Treasury finalized these regulations notwithstanding extensive taxpayer comments that there was no evidence that in "arm's-length" transactions, any buyer ever accepted a cost sharing arrangement that included the future, speculative costs associated with the enhanced value of a participant's business (which might increase its equity value).

Altera Decision

Altera Corp. is a U.S. corporation with a Cayman Islands subsidiary. Under their cost sharing agreement, the U.S. parent required the Cayman subsidiary to make cost-sharing payments to the U.S. parent of over $100 million a year to develop certain intellectual property. But in determining those payments, compensation of the U.S. employees derived from stock options was excluded. The IRS claimed that the costs shared should have been $15 to $25 million more, taking in account the stock option compensation, and effectively reversed Altera's deduction for the costs that the IRS contended should have been allocated to the Cayman subsidiary.

The IRS argued that the 2003 regulation (Reg. section 1.482-7(d)(2)) was a proper exercise of its rule making authority. The taxpayer argued the regulation was arbitrary and not consistent with the rationale asserted by the IRS in issuing the regulation. In a rare opinion upholding a taxpayer challenge to a regulation, the Tax Court held the final regulation invalid because:

"Treasury failed to rationally connect the choice it made with the facts found, Treasury failed to respond to the significant comments when it issued the final rule, and Treasury's conclusion that the final rule is consistent with the arm's-length standard is contrary to all of the evidence before it."

The case points very specifically to the importance of filing comments on regulations. It was the strong arguments made by commentators on the proposed regulation that convinced the Tax Court that there was no empirical evidence supporting Treasury's view that arm's-length parties would share stock-based compensation costs; instead, the evidence was the opposite, as the commentary included several examples of third-party arrangements where share-based compensation was specifically excluded from the cost pool. This led to the court invoking the "reasoned decision making" Administrative Procedure Act standard of review from *State Farm* (463 U.S. 29 at 43 (1983)) and the *Chevron* "Step 2" arbitrary and capricious standard. *Chevron* (467 U.S. 837, 842-843 (1984)). This was a significant loss to Treasury and the IRS as courts typically are deferential in reviewing Internal Revenue Code regulations, affording considerable discretion to the Treasury and the IRS. Notably, the Tax Court confirmed that the APA is applicable to Treasury regulations, holding that the IRS is no different from any other agency in that respect, following *Mayo* (562 U.S. 44 at 55 (2011)).

What Does this Mean for Multinationals?

Based on the *Altera* decision, U.S. corporations that have been following the final 2003 regulation requiring the allocation of stock-based compensation in cost sharing arrangements should consider removing such costs going forward and filing protective amended returns for past years to preserve the ability to claim refunds. It is unknown whether the IRS will appeal the opinion, but it seems probable given the potential for the holding to support challenges to other regulations where comments and supporting evidence were not afforded due regard. In most cases, removing share based compensation costs from the cost sharing pool would increase U.S. tax deductions (i.e., removing an offset) for compensation paid to employees, particularly if the allocation of the costs would not result in a current tax benefit to the non-U.S. subsidiary.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

James P. Klein (bio)
New York
+1.212.858.1447
james.klein@pillsburylaw.com

William E. Bonano (bio)
San Francisco
+1.415.983.1248
william.bonano@pillsburylaw.com

Susan P. Serota (bio)
New York
+1.212.858.1125
susan.serota@pillsburylaw.com

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