INSIGHT: Practical Implications of Denial of Review in ‘Altera v. Commissioner’

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On June 22, 2020, the U.S. Supreme Court declined to issue a writ of certiorari in Altera v. Commissioner, thus leaving intact the U.S. Court of Appeals for the Ninth Circuit’s 2019 decision upholding the validity of the Treasury regulations that require related parties to share the costs of stock-based compensation (SBC) as a component of their intangible development costs (IDCs) in cost sharing arrangements (CSAs). That split Ninth Circuit decision reversed the decision of the Tax Court, which had—in a rare en banc unanimous opinion—invalidated those regulations on the grounds that they violate the Administrative Procedure Act, 5 U.S.C. Sections 701706.

Although the denial of certiorari brought an end to the Altera case, it has not brought an end to the Altera issue. Many taxpayers continue to disagree with the Treasury regulations that govern SBC costs in CSAs, and they can seek judicial recourse from courts that are not bound by the Ninth Circuit’s decision. The Internal Revenue Service, on the other hand, appears ready to enforce and defend its regulation against such challenges. At least until another court weighs in on the issue, taxpayers contemplating their return positions—both past and future—must choose between the dueling decisions of the split Ninth Circuit (an appellate court with a limited geography) and the unanimous Tax Court (a nationwide trial court that tends to adhere to its own precedent). That split in authority is not the only complicating factor for taxpayers.

During the eight year pendency of the Altera litigation, practitioners and academics have written dozens of articles and blog posts debating the merits of the SBC regulations and the various court opinions. Many of those articles raise questions and arguments that are important to tax administration as a whole. This article eschews those issues in favor of a more practical question: given the current state of authority, what factors should taxpayers consider now when approaching the Altera issue on their own tax returns?

Specifically, we address the following topics:

- Tax return filing positions
- Options for future challenges to the SBC regulations
- Reverse clawback contractual provisions to comply with the Ninth Circuit opinion
- Possible future clawback issues if Altera is overruled
- Implications for platform contribution transaction (PCT) valuations
- Whether taxpayers should continue using qualified CSAs
- Accounting Standards Codification (ASC) 740 considerations

Tax Return Filing Positions

Taxpayers and practitioners who are considering excluding SBC costs from their CSAs must reconsider what level of authority such a position would occupy, in light of the current state of the law. Under IRS Circular 230 and Internal Revenue Code Section 6694, there...
must be at least substantial authority for any return position (or alternatively, the position need only have a reasonable basis if adequately disclosed to the IRS). Many sources present substantial authority and reasonable basis in terms of odds of success on the merits (40–45% and 20–25%, respectively), but the regulations frame these standards differently. Instead, the regulations compare taxpayers' positions against an exclusive list of "authorities," which includes (inter alia) the Internal Revenue Code; regulations (final, temporary, and proposed); revenue rulings and revenue procedures; tax treaties; court cases; committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill’s managers; general explanations of tax legislation prepared by the Joint Committee on Taxation (i.e., Blue Books); and notices, announcements and other administrative pronouncements. A position has substantial authority only if the total weight of favorable, permissible authorities is "substantial" in relation to that of all the unfavorable authority. By contrast, the reasonable basis standard generally requires that a position only be "reasonably based" on one or more of the permitted authorities. The regulations cite age of authority, commonalities of fact, and persuasiveness as relevant factors when weighing authorities.

The conflicting judicial opinions in Altera present some thorny questions for determining the relevant weight of authorities. In general, the weighing of authorities is agnostic to the taxpayer’s jurisdiction; taxpayers are generally required to weigh relevant cases from all circuits, even ones to which they cannot appeal. Where a Circuit Court’s opinion overrules the Tax Court’s opinion, however, the analysis will vary depending on the taxpayer’s jurisdiction. For taxpayers who have a right of appeal to that Circuit Court (i.e., Ninth Circuit taxpayers in the case of the Altera issue), the Tax Court’s opinion "does not continue to be an authority to the extent it is overruled or modified," although the authorities that the Tax Court cited may still provide support for the taxpayer’s position. For taxpayers outside that circuit, however, the Tax Court opinion will continue to be an "authority" for this purpose, despite having been reversed or overruled. A taxpayer’s location will therefore be an extremely important consideration for the Altera issue. Taxpayers outside the Ninth Circuit can continue to treat the 15-0 Tax Court opinion as an authority, whereas taxpayers within the Ninth Circuit cannot.

Taxpayers outside the Ninth Circuit, who can treat the Tax Court decision as authority, undoubtedly have an easier road to at least substantial authority or reasonable basis than their counterparts in the Ninth Circuit. But the regulations require taxpayers to weigh all authorities, and in this case there is significantly more to consider than simply the Tax Court’s and Ninth Circuit’s opinions in Altera. A full discussion of all authorities is beyond the scope of this article, but taxpayers should consider their positions in light of other authorities, including: (1) the legislative history surrounding the commensurate with income standard; (2) the Preamble to Treasury Regulations Section 1.482-7 (2003), in light of relevant administrative law standards; and (3) the history of the SBC regulations in cases such as Xilinx v. Commissioner.

Taxpayers would be well-advised to fully consider the impact of all such authorities, and to the extent that they chose not to share the costs of SBC under their CSAs, to have a well-documented file supporting their position. For taxpayers located outside the Ninth Circuit, the Tax Court opinion and other pertinent sources of authority create at least substantial authority for a filing position. Although the Tax Court opinion is no longer a source of "authority" for taxpayers in the Ninth Circuit, the remaining authorities, when considered together, create at least a reasonable basis for a position that excludes SBC costs, which if combined with appropriate disclosure provides such taxpayers with a valid filing position.

Possibilities for Future Challenges to the SBC Regulations

Shortly after the Ninth Circuit overturned the Tax Court, the IRS publicly instructed its agents to once again pursue enforcement of Treas. Reg. Section 1.482-7(d)(3) (revoking a prior directive to the contrary, which had been issued to preserve resources while the government appealed the Tax Court’s adverse Altera decision). See Directive LB&I-04-0719-008 (July 31, 2019). It is safe to assume that some taxpayers will continue to exclude SBC Costs from CSAs, that the IRS will challenge those return positions, and that future litigation of this issue remains likely.

Taxpayers in the Ninth Circuit can still challenge the validity of Treas. Reg. Section 1.482-7(d)(3) in court, although their options are somewhat limited. Under the Golsen Rule, the Tax Court will follow the clearly-established law of the Court of Appeals to which a case before it arises, even if that law contradicts Tax Court precedent. Golsen v. Commissioner, aff’d on other grounds. Thus, for cases arising in the Ninth Circuit, the Tax Court will follow the Ninth Circuit’s Altera decision and therefore treat the SBC regulations as valid. Federal District Courts (and Bankruptcy Courts) in the Ninth Circuit are also bound to follow Ninth Circuit precedent, rendering those courts equally unsuitable for taxpayers seeking to challenge the regulations. The only judicial avenue left available to taxpayers in the Ninth Circuit is to fully pay all tax, file a claim for refund, and then sue for refund in the Court of Federal Claims. The Court of Federal Claims, somewhat like the Tax Court, is a court of nationwide jurisdiction, and follows precedent from the Court of Appeals for the Federal Circuit (rather than to any of the geographic Circuit Courts).

Taxpayers outside the Ninth Circuit remain free to press their case in the Tax Court. That is good news for litigation-minded taxpayers, because the Tax Court remains free to follow its own decision in Altera for all cases outside of the Ninth Circuit. The Golsen Rule notwithstanding, the Tax Court has a strong history of adhering to its own precedents. In fact, Golsen was a compromise—the court had previously refused to follow any Circuit Court ruling that contradicted Tax Court precedent in Lawrence v. Commissioner. Unlike most other Federal trial courts, the Tax Court views its deference to a Court of Appeal as a matter of judicial economy rather than one of authority. The upshot is that the Tax Court, historically, is reluctant to change its views, even after appellate reversal. For instance, the
Tax Court rather famously refused to reconsider its holding in the [Redlark case](https://www.bna.com/redlark-case-tax-court-faces-2903932093/), that two Treasury regulations were invalid until after it had been reversed by five separate Courts of Appeal—and even then, five dissenting judges thought the Tax Court should have stood its ground.

It thus seems unlikely that the Tax Court will be inclined to repudiate the core holding of its own strongly worded, 15-0 opinion in [Altera](https://www.bna.com/altera-case-tax-court-faces-2903932093/), i.e., that the regulations at issue were arbitrary and capricious, and in violation of the APA. This area of administrative law has changed little since 2014, and future cases will present little ground for factual distinction on this point. Whether the rule was a product of “reasoned decision making” will continue to hinge on the 2003 regulatory process, rather than any taxpayer-specific facts. That said, it would be unwise to assume that taxpayer victories in the Tax Court are a certainty. With one surprising twist after another, the [Altera](https://www.bna.com/altera-case-tax-court-faces-2903932093/) case is a helpful reminder that litigation outcomes can be extremely unpredictable in developing areas of law. Very few practitioners originally expected the Tax Court would issue a forceful unanimous opinion in the taxpayer’s favor, and fewer still subsequently predicted that the Ninth Circuit would overrule a 15-0 opinion.

And no one foresaw the possibility of Judge Reinhart casting a deciding vote several months after his death, necessitating an appellate “do-over” that delayed the case’s resolution by over a year and led to the Ninth Circuit’s [sua sponte](https://www.bna.com/sua-sponte-case-tax-court-faces-2903932093/) request for briefing on whether attempts to invalidate these regulations on procedural grounds might be time-barred by 28 U.S.C. Section 2401(a), which generally prohibits such suits six years after regulations are promulgated. The Department of Justice rightly disclaimed that theory, citing fairness grounds both with respect to case’s procedural posture (the issue hadn’t been raised below) and broader policy grounds (when coupled with the Anti-Injunction Act, such a six-year limitations period on the 2003 regulations would have effectively precluded any judicial review for Altera’s 2004-2007 tax years). It remains to be seen whether the [Altera](https://www.bna.com/altera-case-tax-court-faces-2903932093/) issue will continue to defy expectations, as future cases work their way through the courts and as APA jurisprudence in tax further develops.

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**Reverse Clawback: Sharing SBC Costs to Comply with Altera**

In light of the Tax Court’s opinion in [Altera](https://www.bna.com/altera-case-tax-court-faces-2903932093/), many taxpayers who opted not to share SBC costs included reverse clawback provisions in the contractual agreements underlying their CSAs, with the aim of retrospectively sharing SBC costs in the event the SBC regulations were upheld. The contract provisions are known as “reverse clawback” because most CSAs since the finalization of the 2003 Treasury regulations requiring the inclusion of SBC costs have included a clawback provision. These clawback provisions required the CSA participants to “claw back” the value of SBC costs that were shared should the 2003 Treasury regulations be invalidated. Once the Tax Court invalidated the 2003 regulations, some taxpayers amended their agreements to stop sharing SBC costs, but then included a reverse clawback provision that would be triggered under various specified circumstances (for example, when a court decision upholding the regulations becomes final). Reverse clawback provisions frequently obligate CSA participants to make present-year payments reflecting the quantum of SBC costs that should have been shared (rather than go back and amend returns). Typically these reverse clawback provisions do not provide for any interest charge or other collateral effects of recognizing SBC costs in a current period as compared to the period in which they would have been recognized under the 2003 regulations. For many taxpayers, the Supreme Court’s denial of certiorari was a triggering event under a CSA, which means that taxpayers subject to reverse clawback terms now have to grapple with whether and how to implement those provisions, and what the tax consequences will be. Just as important for many companies, however, is the need to make reverse clawback payments while navigating the global disruptions caused by the Covid-19 pandemic.

Although the regulations state that IRS adjustments to cost sharing transactions should be allocated to the tax years in which the intangible development costs were incurred, the proper reporting of reverse clawback payments is not entirely clear. The various considerations discussed below explain why reporting the adjustment in the current year may benefit the taxpayer and in others the IRS from the perspective of the taxpayer’s overall tax liability. What seems clear is that current year reporting is likely to benefit both taxpayers and the IRS from an administrative perspective. For that reason, we encourage the IRS to promptly issue administrative guidance on this issue.

Implementing a reverse clawback by reporting the present-year payments as a current year tax item may or may not be advantageous to a taxpayer from a U.S. tax perspective. SBC costs are usually disproportionately incurred by U.S. participants, and thus reverse clawback provisions taking effect will generally result in inbound payments from foreign affiliates, increasing U.S. taxable income. This may appear to have a tax advantage over amending returns to include the SBC costs on a year-by-year basis, since present year income is taxed at 21% rather than the pre-2018 rate of 35%. In reality, the math may not be so straightforward. On a year-by-year basis, causing the foreign participant to bear the SBC costs in pre-2018 years will generally also decrease foreign E&P, and thereby reduce the amount of the I.R.C. [Section 965](https://www.bna.com/section-965-tax-court-faces-2903932093/) transition tax for the 2017 tax year. The recent revival of the NOL carryback may also blunt the effect of the rate differential during this timeframe. Perhaps most interestingly, some reverse clawback provisions may include SBC costs that were incurred during years with now-closed I.R.C. [Section 6501](https://www.bna.com/section-6501-tax-court-faces-2903932093/) limitations periods. That is, the reverse clawback payment might include amounts that could not otherwise be reached via an IRS examination or even an amended return.

Taxpayers making present-year payments to a U.S. CSA participant for prior-year SBC costs will also need to consider whether the payments are deductible in the foreign participant’s jurisdiction. In some cases, contractual language imposing a duty to make such payments may be helpful. However, foreign tax authorities—just like the Tax Court in [Altera](https://www.bna.com/altera-case-tax-court-faces-2903932093/)—may not accept that sharing SBC costs is consistent with the arm’s-length standard, and there may be substantive and/or administrative issues associated with the fact that the payments relate to costs incurred in prior years.
This problem may be further compounded where the current foreign participant has changed during the last five years, and the current participant will be bearing the reverse clawback expense for SBC costs that arose prior to its joining the CSA. Where domestic relief is not available in the foreign jurisdiction, taxpayers may be able to avail themselves of competent authority assistance under bilateral tax treaties in order to address the double taxation resulting from the inclusion of SBC costs in U.S. income without a corresponding foreign deduction.

For taxpayers with reverse clawbacks who now wish to ensure that they have shared all relevant SBC costs for all years, there is something of a conundrum of how to best do so. As mentioned above, it is not entirely clear how a reverse clawback payment in 2020 will affect the posture of the years that the SBC costs were generated. In the absence of guidance from the IRS, many taxpayers are justifiably concerned that they could be subjected to a whipsaw position if they report reverse clawback payments on their 2020 tax return. Under this scenario, even though a given dollar of SBC cost from 2018 is included in the 2020 reverse clawback payment, IRS Examination might nonetheless insist on making a transfer pricing adjustment to include that same cost in the 2018 cost pools. But because Treas. Reg. Section 1.482-1(a)(3) generally prohibits taxpayers from making taxpayer-favorable transfer pricing adjustments after the original return is filed, that taxpayer could be precluded from later removing that same dollar of income from the 2020 return—thus leading to an unfair double-inclusion of the same item of income. On the other hand, although amending prior year returns in lieu of a reverse clawback payment may solve that particular problem, the IRS (and perhaps a foreign taxing authority) may nonetheless object to the taxpayer violating the terms of its own CSA, particularly if some past years have already closed.

This uncertainty is further compounded by the lack of clarity around how the IRS is likely to view reverse clawbacks as a policy matter. There are many reasons why the government should be pleased that taxpayers added reverse clawbacks to their CSAs. A reverse clawback is a taxpayer’s agreement to voluntarily self-correct past noncompliance, substantially increasing U.S. taxable income without requiring the IRS to expend resources in a transfer pricing examination, and many taxpayers added reverse clawback provisions in 2015 or 2016, long before it seemed likely that the corporate rate would be lowered in the near future. As noted above, some reverse clawback payments may even cover SBC costs from years that the IRS would otherwise be barred from reaching. And they are considerably more administrable, for both taxpayers and the IRS, than every effected taxpayer filing multiple, separate amended tax returns. Notwithstanding, as a policy matter, the IRS has reason to be concerned about the rate differential discussed above, as well as the notion that each tax year is generally supposed to stand on its own. With the wide variation in taxpayers’ circumstances, it is all the more difficult to speculate on what the IRS’s policy decisions might be.

Both taxpayers and the IRS face a daunting task and a great deal of uncertainty in tackling these issues. Even if exhaustive guidance is not feasible, tax administration would greatly benefit if the IRS could provide basic guidance on reverse clawbacks and Altera in time for the current filing season. Most critically, taxpayers who are seeking to come into full compliance need assurance that their efforts will not be rewarded with a double inclusion of the same income. At a minimum, we hope the Service will promptly issue guidance stating that (1) under the principles of Treas. Reg. Section 1.482-1(g), the IRS will not use a reverse clawback provision as a basis to double count income; and (2) if the IRS makes an adjustment to include an item of SBC in a prior year, that Treas. Reg. Section 1.482-1(a)(3) would not bar the taxpayer from removing that same cost from an already-filed reverse clawback position, if necessary to avoid a double-inclusion. Beyond that basic guidance, we also envision that the IRS could create one or more safe harbors that would dramatically reduce controversies and administrative compliance costs.

Future Clawback Issues if Altera is Later Overturned

As noted above, clawback provisions provide that the CSA participants will recalculate their IDC payments to exclude SBC costs should the 2003 Treasury regulations be overturned. Many of these provision cover IDC payments stretching back years, often to 2003 or at least to the beginning of the particular CSA. As years have passed, the amounts that would be withdrawn from the CSAs and subject to repayment, typically from the U.S. to one or more offshore participants, can be enormous. As stated by several briefs in support of Altera’s Supreme Court certiorari petition, there do not appear to be any challenges to the 2003 Treasury regulations that are currently pending in the courts or that are about to go to court. This is not terribly surprising, as most taxpayers were sharing SBCs prior to the 2015 Tax Court opinion. Some taxpayers stopped sharing SBCs in 2015, but more began to take that position in 2016 and later. Many taxpayers included a Form 8275-R disclosing their position to the IRS with their returns.

However, it takes a long time to move such a case through the audit process and then into litigation. Altera required almost 15 years from filing its 2004 tax return until the litigation ended in the Supreme Court. Putting that experience into the context of a taxpayer now following the 2015 Tax Court opinion in another Circuit, it might well be 2030 before there would be an opportunity to ask the Supreme Court to resolve a future circuit split. At that point, should the Supreme Court strike down the regulation, some taxpayers might have 25 years of SBC costs to unwind. It is important for taxpayers that are filing returns following the regulations to consider whether they are prepared to see the consequences of such a potentially massive swing in their financial position. Of course, what the tax climate of 2030 will be is anyone’s guess. Similarly, the business and regulatory environment could be very different from today. Taxpayers who are now going to follow, or who continue to follow, the 2003 regulations may want to revisit their CSAs and determine whether their clawback provision is still suitable. However, taxpayers considering revising their agreements to eliminate clawback payments to foreign CSA participants should consider the foreign implications of doing so as well.
Implications for PCTs

Taxpayers that are making a change to the treatment of SBCs for their CSAs should also consider the potential implications of such a change for their PCTs (including any subsequent PCTs). PCT valuations using transfer pricing methods that relied upon financial projections, such as the commonly-used income method, are directly affected by the inclusion or exclusion of SBC in the financial projections. Under the income method, the value of the PCT is the difference between the PCT payor’s cost sharing and licensing alternatives. The cost sharing alternative is present value of reasonably anticipated residuals over the duration of the CSA. Residuals have been reduced by, among other things, cost contributions to the CSA which either include or exclude SBCs. If the financial projections used in the income method excluded SBCs that are now going to be included in cost sharing payments, then the value of the PCT was likely overstated.

The first step for taxpayers wanting to address potential inconsistent treatment of SBC expenses in their PCTs is to perform a thorough analysis of how SBCs were treated in their PCTs. A good place to start is with a review of the PCT agreement. Similar to the clawback and reverse clawback clauses present in many CSAs, some PCT agreements also include specific terms that address the treatment of SBCs under different possible outcomes of Altera. However, many taxpayers will find that their PCT agreements are silent with respect to SBC. PCT agreements that do not directly address SBC may nonetheless include terms that allow for adjustments to the PCT in order to avoid double taxation, conform to transfer pricing regulations, and/or to maintain adherence to the arm’s-length standard. Taxpayers are advised to carefully review the terms of their PCT agreements to determine if and how they provide for adjustments to the PCT resulting from a change in the treatment SBC expenses, bearing in mind that the terms in intercompany agreements provide helpful support in documenting the intentions of the parties at the time the agreement was executed, but are not dispositive in defining final outcomes, which must be consistent with the arm’s-length standard.

As a next step, taxpayers should revisit the economic analysis of the PCT payment to assess any quantitative impact a change in the treatment of SBCs has on the PCT valuation. In making this assessment, taxpayers will need to answer several important and difficult economic questions. For example, taxpayers must determine the appropriate measure of SBC expense to reflect in the financial projections. The default rule in Treas. Reg. Section 1.482-7(d)(3)(iii) is that the cost attributable to SBC for purposes of a CSA is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that SBC. However, the regulations allow taxpayers that qualify to make an election to use the fair value of the stock options reflected as a charge against income in audited financial statements, and some taxpayers may have made such an election prior to ceasing cost-sharing payments. This brings up a related economic issue: should taxpayers look to forecasts of SBC that were available at the time of the PCT, or should they look to the expenses as actually realized (including the potential impact of clawback arrangements)? The answer to these questions can have a material impact on the PCT valuation, particularly for previously private taxpayers that have gone public. In addressing these questions, taxpayers may also need to consider whether other assumptions in the income model, particularly discount rates, are still appropriate. Unfortunately, the answers to these critical economic questions are not clear. They must take into account and be consistent with the taxpayer’s overall strategy for changing the treatment of SBC in its CSA, which brings us to our third step, considering the options available for making adjustments to PCTs.

In assessing available options for PCT adjustments, the first step is to look at the form of the PCT payment, and what portion of the PCT payment remains outstanding. In making PCT adjustments to prior years, such as through filing qualified amended returns, taxpayers are bound by Treas. Reg. Section 1.482-1(a)(3), which limits the taxpayer’s use of I.R.C. Section 482 and, in particular, prohibits decreasing U.S. taxable income on untimely or amended returns based on adjustments to transfer pricing. Fortunately, Treas. Reg. Section 1.482-1(g)(4) allows for setoffs, which possibly apply with an inclusion of SBC expense has increased U.S. income by pushing SBC expense to the foreign cost sharing participant, thereby allowing for a matching portion of any PCT adjustment to offset the increase. Taxpayers with contingent PCT payments remaining may consider adjusting those remaining payments prospectively to reflect the impact of SBC on the PCT valuation. Here again, alignment with the treatment of SBC for purposes of the CSA is advised.

Finally, taxpayers must consider the potential reactions to their PCT strategy by the tax authority in the tax jurisdiction of the foreign cost sharing participant(s). This is an increasingly important consideration in the wake of the many recent BEPS-related intangible property migrations.

Should Taxpayers Terminate CSAs?

Taxpayers’ principal objection to including SBC costs in IDCs was that doing so overstated IDCs and therefore resulted in higher U.S. taxable income than would occur if the parties transacted on an arm’s-length basis. This argument is particularly persuasive for taxpayers that are required to use the default method of accounting for SBC costs. Under the default method, SBC costs are determined based on the SBC deductions allowable for federal income tax purposes, e.g., generally the spread at the time of exercise for stock options and the fair market value of the stock at the time of vesting for restricted stock. To the extent that a company’s stock appreciates significantly between the grant date and the exercise or vesting date, as the case may be, this measure of SBC costs could be substantially more than the cumulative expense that would be recorded for financial statement purposes. Unrelated parties would be unlikely to agree to share costs based on the unknown (and uncapped) future value of the other party’s stock.

One remedy for this problem has been available all along: taxpayers may adopt a contractual cost sharing arrangement that does not qualify under the requirements of Treas. Reg. Section 1.482-7 (an “NQCSA”). This can be accomplished by failing to satisfy the administrative rules of Treas. Reg. Section 1.482-7(k), including the obligation to file annual CSA statements. Whether an NQCSA satisfies the arm’s-length standard
is determined based upon the rules under section 482 regulations other than Treas. Reg. Section 1.482-7. Thus, to the extent that one participant makes intangibles available to another participant, an appropriate charge should be determined consistent with Treas. Reg. Sections 1.482-4 through 1.482-6. In addition, to the extent that one party performs development activities that benefit another party, an appropriate service charge is determined under Treas. Reg. Section 1.482-9. If such a service charge is determined under a cost-based method, any activities that benefit both the service provider and the related party must be allocated using an appropriate method.

The benefits of switching to an NQCSA could be significant. The OECD’s Base Erosion and Profit Shifting project has resulted in the adoption of economic substance requirements, as well as the amendment of the OECD’s transfer pricing guidelines to provide that a cost sharing participant must perform activities related to the development, enhancement, maintenance, protection, and exploitation of intangibles in order to be entitled to a full return on its legal ownership of the developed intangibles. These developments have caused many multinational taxpayers to consider the foreign participation in QCSAs from tax havens to treaty jurisdictions where the multinational maintains a significant employee presence. To the extent that the requirement to share SBC costs under Treas. Reg. Section 1.482-7 results in a foreign participant being responsible for IDCs in a given year that exceeds the arm’s-length charge for the benefits it receives, a QCSA could result in a double disallowance of deductions for such excess. Because the charges under an NQCSA would be determined under the general arm’s-length standard, on the other hand, the risk of the multinational enterprise losing deductions in any year should be reduced, as both countries would apply a more flexible and consistent approach than the formulaic rules of Treas. Reg. Section 1.482-7.

Before the enactment of the 2017 tax law, taxpayers preferred to use QCSAs for four principal reasons. First, Treas. Reg. Section 1.482-7 does not require the participants to have a contractual agreement with a related foreign person allowing reductions of its deductible IDCs, including pro rata reductions of its deductible IDCs, including

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Whether the BEAT benefits of a QCSA outweigh the detriments of maintaining a QCSA will depend upon a taxpayer’s particular facts and expectations. In general, if using a NQCSA were to cause a taxpayer to become an “applicable taxpayer” and the taxpayer’s BEAT liability would exceed its regular tax liability, a QCSA may still be optimal. However, if a taxpayer is not likely to be subject to the BEAT and it expects the inclusion of SBC costs in its IDCs to expose it to significant double taxation, an NQCSA may be preferable.

The ability of a taxpayer to disqualify its QCSA retrospectively is less clear. Most taxpayers will have continued to satisfy the administrative requirements under Treas. Reg. Section 1.482-7(k), even if they stopped sharing SBC. In such a case, the IRS must treat the arrangement as a QCSA if the taxpayer reasonably concluded that the arrangement was a QCSA. Moreover, even if a taxpayer wants to disclaim the qualification of its arrangement, the IRS may treat the arrangement as a QCSA if it concludes that doing so provides the most reliable measure of an arm’s-length result. In order to prevent itself from being whipsawed by taxpayers using the default method for valuing SBC costs based on whether their stock has appreciated significantly or not, the IRS may be inclined to exercise its authority to treat all such arrangements as QCSAs for past periods. If so, a taxpayer’s only recourse may be to challenge the IRS’s determination in court (which may be difficult post-Altera) or, in a treaty situation, argue to the competent authorities that the application of the SBC regulations do not provide the most reliable measure of an arm’s-length result.

**ASC 740 Considerations**

The discussion above highlights the many complexities that CSA participants now face with respect to both previously filed and future returns. In addition, taxpayers that issue financial statements must consider how to account for tax return positions under the recognition and measurement framework of ASC 740.

As a primer, ASC 740-10-25-6 and 55-3 require that an entity only recognize the effects of a tax position if, based on the technical merits, it is more likely than not the tax position would be sustained if the taxpayer took the dispute to the court of last resort. A recognized tax position (i.e., a position meeting the more likely than not recognition threshold) is measured under the guidance of ASC 740-10-30-7 as the largest amount of tax benefit for which the likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information is greater than 50%.

Applying the recognition and measurement guidance requires significant judgment and an understanding of taxpayers’ individual facts and circumstances. However, the Supreme Court’s denial of certiorari in the Altera case raises many questions for companies to consider.

Taxpayers who may have not shared SBC costs on past U.S. federal income tax returns and who previously concluded that a benefit was recognizable under ASC 740 should consider whether the Supreme Court’s action provides new information with respect to the prior analysis and conclusions. Factors to consider in assessing whether the recognition threshold is met may include whether the recent developments change the prior conclusion regarding the technical merits of the tax position to either above or below more likely than not, assuming it was heard and a decision was rendered by the Supreme Court in a hypothetical later case. If a company were to conclude the recognition threshold is met, all evidence is considered regarding the measurement attribute including, but not limited to, the taxpayer’s ability to negotiate, the taxpayer’s willingness to litigate the position and the taxpayer’s appellate court jurisdiction, as well as the potential for the Supreme Court to accept or deny certiorari in the future.

To the extent a clawback or reverse clawback provision is triggered, or to the extent a reserve is necessary based upon the analysis of the recognition threshold or measurement attribute, taxpayers should consider the potentially complex calculations associated with the impact, including any indirect effects. These impacts may recharacterize transfer pricing payments, change past or expected future SBC deductions, require mandatory payments between parties, adjust earnings and profits (including the impact on the section 965 transition tax inclusion) and change past or future taxable income that would potentially change valuation allowance judgments, among other relevant implications.

**Conclusion**

The Supreme Court’s denial of certiorari in Altera leaves taxpayers without any prospect that the SBC regulations will be successfully challenged in the near term, though later challenges may be expected as these issues percolate through the courts in other circuits. For now, this means different things for different taxpayers. Return filing positions may depend in part on whether a taxpayer is located within the Ninth Circuit, while other issues—such as reverse clawback, ASC 740 issues, and whether to continue in a QCSA—may depend on a taxpayer’s specific facts. All of these issues can involve significant complexity, and all should be considered as taxpayers work through the implications of the end to the Altera saga.

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