No. 19-1009

In the Supreme Court of the United States

ALTERA CORPORATION & SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR PETITIONERS

GINGER D. ANDERS
Munger Tolles & Olson LLP
1155 F Street NW
Washington, DC 20004

MARK R. YOHALEM
Munger Tolles & Olson LLP
350 S. Grand Avenue
Los Angeles, CA 90071

A. DUANE WEBBER
PHILLIP J. TAYLOR
JOSEPH B. JUDKINS
Baker & McKenzie LLP
815 Connecticut Avenue NW
Washington, DC 20006

NICOLE A. SAHARSKY
Counsel of Record
BRIAN D. NETTER
MINH NGUYEN-DANG
Mayer Brown LLP
1999 K Street NW
Washington, DC 20006
(202) 263-3000
nsaharsky@mayerbrown.com

DONALD M. FALK
Mayer Brown LLP
3000 El Camino Real #300
Palo Alto, CA 94306

THOMAS KITTLE-KAMP
WILLIAM G. MCGARRITY
Mayer Brown LLP
71 S. Wacker Drive
Chicago, IL 60606

Counsel for Petitioners

TABLE OF CONTENTS

Page

Introduction 1

Argument 3

A. This case is undeniably exceptionally important 3

B. The government's revisionist history cannot obscure the serious errors warranting this Court's review 5

C. This Court should grant certiorari now 10

Conclusion 13

Appendix – Additional reporting on the *Altera* issue in SEC filings since the petition was filed 1a

TABLE OF AUTHORITIES

Cases **Page(s)**

Chevron, U.S.A., Inc. v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) ..... *passim*

Chisom v. *Roemer*, 501 U.S. 380 (1991) 6

Encino Motorcars, LLC v. *Navarro*, 136 S. Ct. 2117 (2016) 8

Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. *State Farm Mut. Auto. Ins.*, 463 U.S. 29 (1983) .. 8, 9

SEC v. *Chenery Corp.*, 332 U.S. 194 (1947) 8

Statute and regulations

Administrative Procedure Act, 5 U.S.C. 551 *et seq.* 2, 8, 9

26 C.F.R.:

Section 1.482-1(b)(1) 6

Section 1.482-4(f)(2) 6

Section 1.482-7(d)(2) (2003) 6

Other authorities

Merle Erickson et al., Altera *and the GAAP Financial Statements of Other Public Firms*, 167 Tax Notes Federal 945 (2020) 3

Ryan Finley, *IRS Will Continue* Altera *Fight in Other Circuits If Needed*, Tax Notes (Jan. 6, 2020) 4

IRS, Notice 88-123, *A Study of Intercompany Pricing Under Section 482 of the Code*, 1988-2 C.B. 458 6

IRS, *Report on Application and Administration of Section 482* (1992) 11

TABLE OF AUTHORITIES
(continued)

Other authorities – continued **Page(s)**

OECD, OECD Model Tax Convention on Income and on Capital (July 22, 2010), https://perma.cc/3JW9-N5U3 10

OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 10, 2017), https://perma.cc/T9NB-L49H 10, 11

U.S. Dep't of the Treas., *Technical Explanation of the Convention for the Avoidance of Double Taxation, U.S.-Pol.* (2013), https://perma.cc/5MQZ-XKZU 11

U.S. Dep't of the Treas., United States Model Income Tax Convention (Feb. 17, 2016), https://perma.cc/GY49-H3ES 11

In the Supreme Court of the United States

No. 19-1009

ALTERA CORPORATION & SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR PETITIONERS

INTRODUCTION

The decision below expands agency deference far beyond the breaking point. The government took one position in rulemaking, and another in litigation. A panel of the Ninth Circuit not only accepted the government's new position, but gave it *Chevron* deference. The effect was to allow the government to make a sea change in tax law without providing any notice of the change or opportunity to comment on it. Enough is enough; it is time for this Court to step in.

This case is undeniably important. The government does not dispute that the decision below will have a multi-billion-dollar impact on American businesses. Nor does it dispute that the stock-based compensation issue affects many companies in a wide range of industries. And the government cannot dis-

pute the significance of the Ninth Circuit's administrative law holdings. Nineteen federal judges found the government's position indefensible – including fifteen judges of the Tax Court, in an opinion notable for its "uncommon unanimity and severity of censure." Pet. App. 165a (Smith, J., dissenting from denial of rehearing).

Against that backdrop, the government's response is to argue the merits. The government claims that it followed all of the rules applicable to administrative agencies, because its new position was apparent from the rulemaking record all along. The government's reimagining of this case blinks reality. The arm's-length standard always has depended on how unrelated parties behave in the real world, and nothing in the administrative record gave notice of the government's supposed intent to abandon that settled understanding. The Court need not take Altera's word for it; none of the companies, industry groups, or tax professionals that participated in the rulemaking noticed this supposed change. Nor did any of the fifteen Tax Court judges.

The government made up a new rationale for the regulation in litigation, and the Ninth Circuit deferred to it under *Chevron*. The government says this was perfectly fine, because a court may address *Chevron* first. That misses the point. The problem is that the Ninth Circuit used *Chevron* to excuse compliance with the Administrative Procedure Act. When a regulation is invalid under the rationale the agency advanced during rulemaking, a court may not resurrect it on some newly imagined basis. This Court should grant certiorari to review the Ninth Circuit's extravagant expansion of *Chevron*.

The Ninth Circuit's decision has created massive uncertainty for multinational companies. The largest

global accounting firms have taken the unprecedented step of asking this Court to weigh in. Over a dozen former foreign tax officials have warned that the decision below will spawn international tax disputes and lead to double taxation. The government says wait for another case, but it identifies no other case in the pipeline. The issues have been fully vetted; there is no reason to wait. The Court should grant certiorari now.

ARGUMENT

A. This Case Is Undeniably Exceptionally Important

1. It is undisputed that the financial impact of the Ninth Circuit's decision is enormous. In SEC filings, 86 companies have documented a tax impact of at least $6.7 billion. Pet. 26-27 & App. I; App., *infra*, 1a-2a; see Cisco Br. 3 (tax at issue for 25 *amici* "exceed[s] $5 billion"). The full impact no doubt is much higher, because some publicly held companies did not report dollar amounts, and privately held companies are not required to file reports with the SEC. Pet. 25-26.

The impact is not only significant in the aggregate, but also with respect to the financial statements of individual companies. One study of publicly traded companies concluded that the tax due because of the Ninth Circuit's decision will amount, on average, to 30% of the companies' annual income taxes. See Merle Erickson et al., Altera *and the GAAP Financial Statements of Other Public Firms*, 167 Tax Notes Federal 945, 950 (2020).

Those financial effects will not be limited to a certain sector of the U.S. economy, but will be felt by large and small companies across many different industries. Pet. 25-26; see NAM Br. 1-4. That is why this case has received significant and sustained media

attention, Pet. 22 n.2, and why so many companies, industry groups, and tax professionals have urged this Court to grant certiorari.

The stock-based compensation issue has immense prospective importance. The current regulation is materially the same as the regulation at issue, Pet. 27, and the government has vowed to continue enforcing it aggressively, see Ryan Finley, *IRS Will Continue* Altera *Fight in Other Circuits If Needed*, Tax Notes (Jan. 6, 2020).

The government does not dispute any of this. The expected impact of the decision below on the U.S. economy alone justifies this Court's review. See Pet. 28 & n.3.

2. The government also does not dispute the importance of the administrative law principles at stake.

This Court has recently and repeatedly expressed concern about the broad, unchecked power of administrative agencies. Pet. 23-24 (citing cases). This case squarely implicates those concerns. Nineteen federal judges called the agency's actions "the epitome of arbitrary and capricious rulemaking." Pet. App. 146a (Smith, J., dissenting from denial of rehearing); *id.* at 49a (O'Malley, J., dissenting); *id.* at 139a (Tax Court). The dissenting judges on the Ninth Circuit warned that the panel's use of *Chevron, U.S.A., Inc.* v. *Natural Resource Defense Council, Inc.*, 467 U.S. 837 (1984), to resurrect the regulation "sends a signal that executive agencies can bypass proper notice-and-comment procedures as long as they come up with a clever post-hoc rationalization by the time their rules are litigated." Pet. App. 167a (Smith, J., dissenting from denial of rehearing).

Those serious concerns about potential consequences for other administrative agencies, shared by

a significant number of federal judges, cement the need for this Court's review.

B. The Government's Revisionist History Cannot Obscure The Serious Errors Warranting This Court's Review

1. Rather than dispute importance, the government argues the merits. As the petition explained, the Ninth Circuit violated established rules of administrative law by upholding an arbitrary and capricious regulation based on a rationale presented for the first time in litigation, and even giving the new rationale *Chevron* deference. Pet. 14-22. The government's defense of the decision below rests entirely on its argument that the new rationale was in the rulemaking record all along. Br. in Opp. 18-20. The government is wrong, and without that argument, its entire case falls apart.

The parties agree that the government can only collect the tax at issue if it satisfies the arm's-length standard. The arm's-length standard has a settled meaning: A transaction meets the arm's-length standard if it is consistent with evidence of how unrelated parties behave in comparable arm's-length transactions. Pet. 4-5. Yet according to the government, the Treasury Department "changed the legal landscape" in the 2003 regulation, so that now "comparability analysis plays no role in determining" whether the arm's-length standard is satisfied. IRS C.A. Br. 30.

The problem for the government is that nothing in the administrative record shows this supposed change. The government cites (Br. in Opp. 21) the regulation itself, but the regulation simply restates the government's position that related parties must share stock-based compensation; it does not give content to

the arm's-length standard. See 26 C.F.R. 1.482-7(d)(2) (2003). The government also cites snippets of legislative history that supposedly show Congress's intention to let the Treasury Department make up a new "arm's-length" standard. Br. in Opp. 24. But legislative history is hazardous evidence of congressional intent, especially when (as here) it concerns inapplicable statutory language. Pet. App. 70a-71a (O'Malley, J., dissenting); see Pet. 10. Besides, the question is not what Congress intended when legislating, but what the Treasury Department told the public when promulgating the regulation at issue. The government plainly is grasping at straws.

This is a paradigmatic case of the "watchdog [that] did not bark." *Chisom* v. *Roemer*, 501 U.S. 380, 396 n.23 (1991) (internal quotation marks omitted). Abandoning reliance on comparable transactions and other empirical evidence of unrelated-party behavior would have been a massive change in tax law. The arm's-length standard has always "rel[ied] in one way or another on comparables." IRS, Notice 88-123, *A Study of Intercompany Pricing Under Section 482 of the Code*, 1988-2 C.B. 458, 468 (*White Paper*); see, *e.g.*, Accounting Firms Br. 9-11. Even now, the regulation defines the arm's-length standard as depending on real-world evidence: "A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." 26 C.F.R. 1.482-1(b)(1); see 26 C.F.R. 1.482-4(f)(2). That is consistent with the term's ordinary meaning and with decades of guidance. *White Paper* 474 ("[I]ntangible income must be allocated on the basis of comparable transactions if comparables exist."); Pet. 5-6.

If the government had fundamentally changed that standard, there would have been an uproar. But there was none. In the rulemaking, the government said it was using the arm's-length standard, which depends on empirical evidence, and so the commenters provided that evidence. Pet. 8, 15-16. No one involved in the rulemaking proceeding – none of the affected companies, tax professionals, or other stakeholders – understood the government to be changing the arm's-length standard. See NAM Br. 10 ("The rulemaking did not announce or imply that Treasury was thinking of declaring real-world comparable transactions irrelevant to the arm's-length analysis for cost-sharing."); see also Cisco Br. 9-11; Accounting Firms Br. 8-9.[1]

The Tax Court's silence on this point is especially telling. If the government had signaled its intention to abandon the use of comparables, surely one of the fifteen experts on the Tax Court would have noticed. But none did. Pet. App. 118a-119a. That is because the government's new rationale never appeared in the rulemaking record. And with that, the government's defense of the Ninth Circuit collapses.

2. The unanimous Tax Court found that the regulation cannot be upheld as an application of the settled arm's-length standard, because the record evidence shows that unrelated parties engaging in comparable transactions would not share stock-based compensation. Pet. App. 130a-132a. Because the government

---

[1] The government suggests (Br. in Opp. 22) that one commenter understood that the government was changing position. What that commenter actually said was that the agency "cannot have" had the intent to abandon use of comparables, because that would be a "radical" and unjustified departure from the arm's-length standard. Pet. C.A. Supp. E.R. 167.

did not challenge that holding on appeal, it is now undisputed that the government cannot defend the regulation on the rationale in the administrative record.[2] That should end this case.

But the Ninth Circuit went a different route. When it could not sustain the regulation on the rulemaking record, it accepted a new position the IRS made up in litigation, and even gave that position *Chevron* deference. That violated this Court's clear guidance that a court must "judge the propriety of [agency] action solely by the grounds invoked by the agency," *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947), and may not give *Chevron* deference to a procedurally defective regulation, *Encino Motorcars, LLC* v. *Navarro*, 136 S. Ct. 2117, 2125 (2016).

The government's only response (Br. in Opp. 26) is that a court may conduct a *Chevron* analysis first, before it determines whether the agency followed the notice-and-comment procedures required by the Administrative Procedure Act (APA), 5 U.S.C. 551 *et seq.*, and this Court's precedents, including *Motor Vehicle Manufacturers Association of the United States*, *Inc.* v. *State Farm Mutual Automobile Insurance*, 463 U.S. 29 (1983).

That misses the point. A court cannot rehabilitate a procedurally invalid regulation using *Chevron*. The Ninth Circuit did that here, and the way it did it was by addressing *Chevron* first. Because the Ninth Circuit found the government's *new* approach reasonable under *Chevron*, it decided that the government did not need to cure the problems with the *old* approach in the

---

[2] Because the government did not challenge the Tax Court's holding on appeal, it cannot now attempt to justify the regulation on the ground that the transactions in the administrative record were insufficiently comparable. *E.g.*, Br. in Opp. 23.

rulemaking proceeding. Pet. App. 36a-37a (because Treasury reasonably decided "to do away with analysis of comparable transactions," it was not required to respond to the record evidence of comparable transactions that fatally undercut the government's proposed rule).

The Ninth Circuit's analysis uses *Chevron* to undermine *State Farm*. Even if the government could abandon comparability analysis consistent with the statute and regulations (doubtful), that would only satisfy *Chevron*. To satisfy *State Farm*, the government had to justify its rule under the standard it set out during the rulemaking proceeding. It never did so here because the Ninth Circuit eliminated that requirement.

3. The government's bait-and-switch is indefensible. The government's position amounts to a claim that the arm's-length standard means whatever the government says it means. See IRS C.A. Br. 50 (government's new standard allows it to make its own "internal" judgment about what would be an "arm's-length result"). The government need not provide any evidence, and in fact it can require related parties to do the exact opposite of what unrelated parties do at arm's length, and still call it an "arm's-length result." Br. in Opp. 18-19. And under this new standard, affected parties are hard-pressed to challenge the government's determinations.

The APA required the government to acknowledge and justify its remarkable change in position, and to respond to the many interested parties who would have objected. The Ninth Circuit allowed the government to sidestep all of that. That is a reckless way to make a multi-billion-dollar change to tax law.

C. This Court Should Grant Certiorari Now

1. The Ninth Circuit's decision has created significant uncertainty. That is why three of the "Big Four" accounting firms have joined together to ask this Court to grant review.[3] They urge this Court to intervene immediately because the Ninth Circuit's decision has created "disuniformity and uncertainty" with respect to domestic tax law and financial reporting requirements. Br. 5-6.

Many companies and industry groups echo the accounting firms' concerns. They explain that the arm's-length standard determines the tax treatment of "trillions of dollars of cross-border intercompany transactions" each year, and that the Ninth Circuit's decision has created widespread confusion about the content of the arm's-length standard. NAM Br. 17; see Cisco Br. 2.

The potential international consequences are even more troubling. Almost every U.S. tax treaty incorporates the arm's-length standard. See Pet. 29 & App. J. The United States' treaty partners have always understood the arm's-length standard to depend on an empirical analysis of arm's-length evidence. See, *e.g.*, OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 35 (July 10, 2017) ("'[C]omparability analysis'[] is at the heart of the application of the arm's length principle.") (*OECD Guidelines*), https://perma.cc/T9NB-L49H. In fact, that principle is incorporated into the treaty language itself. See, *e.g.*, OECD, OECD Model Tax Convention on Income and on Capital, art. 9 (July 22, 2010) (directing tax authorities to compare "conditions * * * made or imposed between the two [related]

[3] The fourth accounting firm did not participate because it is Altera's auditor. See Accounting Firms Br. 1 n.2.

enterprises in their commercial or financial relations" with "those which would be made between independent enterprises"), https://perma.cc/3JW9-N5U3; U.S. Dep't of the Treas., United States Model Income Tax Convention, art. 9 (Feb. 17, 2016) (same), https://perma.cc/GY49-H3ES.

The government attempts to downplay (Br. in Opp. 29-30) the international consequences of the Ninth Circuit's decision. But the technical explanations on which it relies (*ibid.*) do not actually support its view. In fact, they support Altera's view: They say that the relevant treaty language should be interpreted using the *OECD Guidelines*, see U.S. Dep't of the Treas., *Technical Explanation of the Convention for the Avoidance of Double Taxation, U.S.-Pol.* 31 (2013), https://perma.cc/5MQZ-XKZU, and the *OECD Guidelines* say (at 35) that the arm's-length standard depends on real-world behavior.

This Court should listen to the eighteen former tax officials from a variety of foreign jurisdictions, who warn that the Ninth Circuit's decision "countenances a departure from the worldwide understanding of what the arm's-length standard means" and will lead to increased disputes among nations and to double taxation of multinational companies. Tax Officials Br. 5, 18-19. That concern was shared by the dissenting judges in the Ninth Circuit. Pet. App. 166a (Smith, J., dissenting from denial of rehearing). And the IRS itself previously has said that "[a]ny deviation from the arm's length standard" would "contradict longstanding international norms" and "raise substantial concerns" among treaty partners. IRS, *Report on Application and Administration of Section 482* at 4-12 (1992). The need for stability and predictability in the international tax system is a powerful reason for this Court to grant review now.

2. Finally, the government suggests (Br. in Opp. 28-29) that the Court should wait for a circuit split to develop. But most of the financial impact will be felt in the Ninth Circuit, Pet. 31, and no other cases are in the pipeline, *id.* at 32. In fact, the accounting firms report that it could take "a decade or more for another case to reach this Court." Br. 6; see NAM Br. 17.[4]

Taxpayers and the IRS are treating this case as *the* definitive case. See Pet. 31-32; Accounting Firms Br. 18-19. The issues have been fully aired in the many opinions below, with the help of briefs from many interested parties. And waiting for a circuit split makes little sense here, because the Ninth Circuit's decision was a startling departure from foundational principles of administrative law. This Court should not permit that decision to go unreviewed.

[4] The Court's resolution of *CIC Services, LLC* v. *IRS*, cert. granted, No. 19-930 (May 4, 2020), will not affect the outcome of this case, because this case does not involve a pre-enforcement challenge, and the government has expressly waived any statute of limitations defense. Pet. App. 22a n.6.

CONCLUSION

The petition for a writ of certiorari should be granted. In the alternative, the Court should grant the petition and summarily reverse the decision of the court of appeals.

Respectfully submitted.

GINGER D. ANDERS
Munger Tolles & Olson LLP
1155 F Street NW
Washington, DC 20004

MARK R. YOHALEM
Munger Tolles & Olson LLP
350 S. Grand Avenue
Los Angeles, CA 90071

A. DUANE WEBBER
PHILLIP J. TAYLOR
JOSEPH B. JUDKINS
Baker & McKenzie LLP
815 Connecticut Avenue NW
Washington, DC 20006

NICOLE A. SAHARSKY
Counsel of Record
BRIAN D. NETTER
MINH NGUYEN-DANG
Mayer Brown LLP
1999 K Street NW
Washington, DC 20006
(202) 263-3000
nsaharsky@mayerbrown.com

DONALD M. FALK
Mayer Brown LLP
3000 El Camino Real #300
Palo Alto, CA 94306

THOMAS KITTLE-KAMP
WILLIAM G. MCGARRITY
Mayer Brown LLP
71 S. Wacker Drive
Chicago, IL 60606

JUNE 2020

APPENDIX

APPENDIX

Additional Reporting On The *Altera* Issue In SEC Filings Since The Petition Was Filed

The following public companies noted the *Altera* issue for the first time in their quarterly (Forms 10-Q) or annual (Forms 10-K) reports filed with the SEC after the petition was filed.*

1. FireEye, Inc., Form 10-K at 102 (Feb. 21, 2020) (headquartered in California) (reporting $9.4 million at stake)
2. KVH Industries Inc., Form 10-K at 35 (Feb. 28, 2020) (headquartered in Rhode Island)
3. SVMK Inc., Form 10-Q at 20 (May 8, 2020) (headquartered in California)
4. Twilio Inc., Form 10-K at 57 (Mar. 2, 2020) (headquartered in California)

The following public companies revised their estimates of the financial impact of the *Altera* issue in their quarterly (Forms 10-Q) or annual (Forms 10-K) reports filed with the SEC after the petition was filed.

1. Electronic Arts Inc., Form 10-K at 34 (May 20, 2020) (headquartered in California) (reporting $80 million at stake; no previous amount reported)

---

* The list was generated by searching Lexis Securities Mosaic, a commercial database of public company filings, for all Forms 10-Q and 10-K filed between February 10, 2020, and the present that mention the opinions in this case issued by the Tax Court or the Ninth Circuit.

2. Facebook Inc., Form 10-Q at 26 (Apr. 30, 2020) (headquartered in California) (reporting $1.64 billion at stake; $1.1 billion reported on January 30, 2020)
3. Fitbit Inc., Form 10-K at 46 (Feb. 27, 2020) (headquartered in California) (reporting $5.3 million at stake; no previous amount reported)
4. Gilead Sciences Inc., Form 10-K at 82 (Feb. 25, 2020) (headquartered in California) (reporting $114 million at stake; no previous amount reported)
5. Sunpower Corp., Form 10-K at 68 (Feb. 18, 2020) (headquartered in California) (reporting $5.8 million at stake; no previous amount reported)
6. Take Two Interactive Software, Inc., Form 10-K at 33 (May 22, 2020) (headquartered in New York) (reporting $19.8 million at stake; no previous amount reported)
7. Teradyne, Inc., Form 10-K at 99 (Mar. 2, 2020) (headquartered in Massachusetts) (reporting $6.3 million at stake; $5-11 million reported on November 8, 2019)