August 8, 2019

With Altera Appeal Still Pending, IRS Signals Intent to Re-Open Audits of Cost-Sharing Issue
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U.S. companies that entered into qualified cost-sharing arrangements (CSAs) with foreign affiliates may soon find themselves in the audit hot seat, as the IRS has officially re-opened the door to examinations of stock-based compensation in CSA structures. The decision, announced in a memo to IRS Large Business & International Division employees that was posted to the IRS website this week, stems from the June decision by the United States Court of Appeals for the Ninth Circuit upholding the validity of the relevant regulations in Altera Corp. v. Commissioner, 926 F.3d 1061.

BACKGROUND

Altera Corp., now a subsidiary of Intel Corp., challenged the validity of Treas. Reg. Sec. 1.482-7(d)(2), which requires participants in qualified CSAs to share stock-based compensation costs in order for the arrangement to pass muster under the arm's-length standard. In a 2015 decision, the Tax Court sided with the taxpayer (145 T.C. 91), finding that Treasury had overstepped its authority in promulgating the regulation, which was therefore held to be invalid.

In January 2018, while the government appealed the decision to the Ninth Circuit, LB&I Commissioner Douglas O'Donnell suspended audits of issues involving stock-based compensation in CSA structures, instructing LB&I examiners to refrain from opening any new inquiries and to cease further development of any such issues already open (assuming the affected taxpayer was amenable to an appropriate extension of the case's statute of limitations). (LB&I Directive LB&I-04-0118-005 (January 12, 2018).) Notably, both the Tax Court and the Ninth Circuit had previously invalidated an earlier version of the regulation at issue, a fact that Commissioner O'Donnell pointed out in his 2018 memo. (See Xilinx Inc. v. Commissioner, 125 T.C. 37 (2005), aff'd, 598 F.3d 1191 (9th Cir. 2010).)

After a procedural twist involving an opinion that was withdrawn following the death of a panel member, a three-judge panel of the Ninth Circuit reversed the Tax Court's decision for Altera in June 2019, agreeing with Treasury that the regulation was, in fact, a reasonable interpretation of the statute it was designed to implement and finding that Treasury had followed all necessary procedural steps in promulgating it.

LATEST DEVELOPMENTS

Altera Corp. filed a petition July 22 to have its case heard by the full appeals court. By August 1, numerous amicus briefs had already been filed in support of the taxpayer by organizations such as the U.S. Chamber of Commerce, KPMG, Deloitte, PwC, and even Xilinx Inc., the prevailing taxpayer in the dispute over an earlier version of the regulations.

Against this backdrop Commissioner O'Donnell announced to LB&I staff that he was "formally withdrawing" the January 2018 directive and that IRS examiners should resume applying the regulations at issue, "including opening new examinations of CSA [stock-based compensation] issues when appropriate." (LB&I Directive LB&I-04-0719-008 (July 31, 2019).)

NAVIGATING THE LANDSCAPE

Altera's pending petition for rehearing coupled with the LB&I audit directive create an uncertain path for taxpayers with CSA structures that may be facing potential (or actual) audits of stock-based compensation issues. On one hand, while the Altera petition is pending, the law in the area may still be considered at worst unsettled (and at best taxpayer favorable, at least outside the Ninth Circuit), and thus affected taxpayers can consider themselves stuck in the same holding pattern on the issue that they've been in for months or years. On the other hand, the LB&I memo signals that the IRS considers the issue settled in its favor, and thus audit attacks could be imminent.

Affected taxpayers should consult with their tax advisors to determine whether implementing structural or computational changes might be advisable (or possibly still premature). Ultimately the decision will depend on a number of factors, such as the materiality of any stock-based compensation, the complexity of the CSA arrangement, the industry, and even the currency of the audit cycle, to name a very few.

It may also be worth strategizing in advance to create a robust audit defense plan so that an affected taxpayer will be prepared to hit the ground running if the IRS should pursue a challenge.

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