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Good Fortune Shipping And The Withdrawn Altera Opinion

By **Patrick Smith** (September 5, 2018, 5:48 PM EDT)


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On Tuesday, July 24, 2018, the U.S. Court of Appeals for the Ninth Circuit issued its much-anticipated opinion in Altera Corp. and Subsidiaries v. Commissioner of Internal Revenue,[1] a case that involves a challenge to the validity of regulations issued under Section 482 of the Internal Revenue Code. Although one of the judges on the Ninth Circuit panel wrote a dissent that would have affirmed the Tax Court's opinion, the decision was a severe disappointment for most tax professionals in private practice, as well as, presumably, the 15 U.S. Tax Court judges whose unanimous opinion[2] was reversed by the decision. But the majority opinion was undoubtedly a cause for celebration for the attorneys in the Internal Revenue Service Office of Chief Counsel and the U.S. Department of Justice Tax Division, as well as for the multiple law school professors who had filed amicus briefs in support of the IRS in the Ninth Circuit.

Later that week, the U.S. Court of Appeals for the District of Columbia Circuit issued its opinion in Good Fortune Shipping SA v. Commissioner,[3] another case involving a challenge to the validity of tax regulations. Good Fortune Shipping has received much less attention than Altera, undoubtedly because the substantive provisions that are at issue in Good Fortune Shipping are of much narrower applicability than those at issue in Altera. However, the District of Columbia Circuit opinion in Good Fortune Shipping represents a strong contrast to the Ninth Circuit's decision in Altera. The District of Columbia Circuit's opinion in Good Fortune Shipping is very similar to the analysis used by the Tax Court in Altera, and rejected by the Ninth Circuit, namely a failure by the IRS and U.S. Department of Treasury to provide an adequate contemporaneous explanation of the reasons supporting the issuance of the challenged regulation provisions. Another reason why the Good Fortune Shipping decision should be given considerable weight is that, in comparison to the other circuits, the District of Columbia Circuit is uniformly recognized as the circuit that has by far the most expertise and experience in dealing with administrative law issues.

In days and weeks following the Altera and Good Fortune decision, there were a number of unexpected and significant developments that substantially undercut the impact of the Altera opinion. First, on Thursday, Aug. 2, 2018, the Ninth Circuit issued an order in the case announcing that Judge Susan Graber of the Ninth Circuit had been appointed to the panel hearing the case, replacing Judge Stephen Reinhardt who had died in March 2018.

In light of the nine-day delay between the issuance of the July 24 opinion and the announcement that Graber would replace Reinhardt on the case, it seems very likely that at the time the July 24 opinion was issued, it was not contemplated that a replacement would be appointed. Instead, it would seem that the announcement of a replacement must have been prompted by some development after the July 24 opinion was issued, possibly an expression of the view by one or more of the Ninth Circuit judges not involved in the case that at a minimum, there needed to be a full functioning panel on the case in the event that Altera wished to file a motion for rehearing.

The next development in the Altera case was even more striking. On Aug. 7 the new panel issued an order withdrawing the July 24 opinion in order "to allow time for the reconstituted panel to confer on this appeal." Once again, in light of the delay between the announcement of Graber's appointment and the order withdrawing the original July 24 opinion, it would seem that the withdrawal may not have been contemplated when Graber was appointed, but was instead prompted by later developments. The most likely possibility would seem to be that Graber expressed the view that, in light of the fact that the outcome in the original opinion depended on the vote of the judge who had died and since been replaced, it was inappropriate to let the original opinion stand as the opinion of the court.

The last significant recent development in Altera occurred on Aug. 16, nine days after the withdrawal of the original opinion, when the new panel in the case issued an order stating that new oral argument in the case will be heard on Oct. 16, 2018. It seems likely that this step may also have been prompted by Graber, who may have decided after an initial review of the briefs in the case and a the recording of the original oral argument that she would like to participate in oral argument, rather than reaching a decision based exclusively on the existing record.

An important reason why the Tax Court's decision in Altera was significant was that it was the first time the validity of a tax regulation was challenged based on the argument that the IRS and the U.S. Department of Treasury's issuance of the regulation violated the Administrative Procedure Act's arbitrary and capricious standard[4]. In a very thorough and well-reasoned opinion, the Tax Court held that the IRS and Treasury had failed to satisfy the "reasoned decision-making" requirement of the arbitrary and capricious standard as interpreted by the U.S. Supreme Court in Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.[5].

The essence of the arbitrary and capricious standard, as interpreted by the Supreme Court in State Farm, is that the agency's decision must have been the product of "reasoned decision making."[6] In order to make it possible for a reviewing court to be able to evaluate the the propriety of an agency's decision and determine whether it was, in fact, the product of reasoned decision-making, the agency must "articulate a satisfactory explanation for its action"[7] at the time the agency makes its decision. As the Supreme Court noted in State Farm, "[w]e have frequently reiterated that an agency must cogently explain why it has exercised its discretion in a given manner, and we reaffirm this principle again today."[8]

The requirement that the agency must explain the reasons for its decision at the time the decision is made is also integrally related to the well-established administrative law doctrine that "an agency's action must be upheld, if at all, on the basis articulated by the agency itself."[9] This doctrine is referred to as the Chenery doctrine, based on two landmark U.S. Supreme Court decisions in the 1940s, Securities Exchange Commission v Chenery Corporation Et Al, in which it was articulated.[10] In order for a court that is reviewing agency action to apply the Chenery doctrine, it is obviously necessary for the agency to have articulated the reasons for its action at the time the action was taken.

The Chenery doctrine also necessarily means that "the courts may not accept appellate counsel's post hoc rationalizations for agency action,"[11] where the agency has not in fact relied on the rationales presented to the reviewing court by the appellate counsel representing the agency. However, despite the general requirement that an agency must explain the reasons for its decision at the time the decision is made, State Farm also noted that the reviewing court will "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned."[12]

The foregoing general background on the APA's arbitrary and capricious standard and State Farm's interpretation of that standard provides the context for a very brief discussion of the Altera case, which in turn provides the context for understanding the significance of the District of Columbia Circuit's decision in Good Fortune Shipping.

The Altera case involved a challenge to the validity of a provision in regulations issued under IRC Section 482 relating to cost-sharing agreements that are entered into between related parties for the purpose of jointly developing intangible property. The challenged provision required that one of the costs that was required to be shared under these types of agreements was the cost of stock-based compensation paid to employees who are working on the intangible development project.

The taxpayer in Altera argued in Tax Court that the IRS and Treasury had violated the APA arbitrary and capricious standard as interpreted in State Farm in issuing the regulations containing this provision because they had not provided adequate support for their conclusion that unrelated parties would agree to share the cost of stock-based compensation in these types of cost-sharing agreements. The standard that has traditionally been applied in evaluating transactions between related parties under IRC Section 482 is whether the terms of the related-party transaction correspond to the terms that would be agreed to by unrelated parties. This standard is referred to as the "arm's-length standard."

The IRS argued in the Tax Court in Altera that the validity of the regulation should instead be evaluated under the two-step test in Chevron USA Inc. v. Natural Resources Defense Council, Inc.,[13] rather than under the arbitrary and capricious standard and State Farm. However, the Tax Court concluded that the arbitrary and capricious standard should be applied, in part because the U.S. Supreme Court in Joel Judulang v Eric H. Holder Jr. Attorney General[14] confirmed that there is substantial equivalence between Chevron step two and the arbitrary and capricious standard.[15] The IRS also argued that the arm's-length standard was no longer controlling with respect to transactions involving intangibles because of the 1986 amendment to IRC Section 482 that added the commensurate-with-income standard with respect to transfers or licenses of intangibles.

The Tax Court agreed with the taxpayer that the IRS and Treasury had violated the arbitrary and capricious standard by failing to provide adequate support for the conclusion that unrelated parties would agree to share the cost of stock-based compensation. The Tax Court also concluded that while the preambles to the proposed and final regulations had referred to the commensurate-with-income standard, nevertheless, these preambles had not asserted that this standard provided a basis for departing from the arm's-length standard — as a result, the Chenery doctrine precluded the Tax Court from using the rationale of an intended departure from the arm's length standard as a basis for upholding the regulation.[16]

As noted earlier, the Ninth Circuit in its withdrawn July 24 opinion reversed the Tax Court in a two to one decision. A detailed analysis of the Ninth Circuit majority opinion is well beyond the scope of the present discussion, but the central element in the majority opinion was an extremely relaxed and undemanding application of the principle noted earlier that a reviewing court will "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned."

The withdrawn Ninth Circuit majority opinion concluded that the references in the preambles to the proposed and final regulations to the 1986 amendment to IRC Section 482 adding the commensurate-with-income standard and the references in these preambles to the legislative history of this 1986 amendment were sufficient to permit "the agency's path [to] reasonably be discerned," namely, according to the withdrawn majority opinion, the path of departing from the arm's-length standard in connection with the requirement to share the cost of stock-based compensation. The withdrawn dissenting opinion in the Ninth Circuit correctly identified the errors in the majority opinion, including the fact that nowhere did the preambles state or imply that the IRS and Treasury viewed the provision in the regulations that required sharing of the cost of stock-based compensation as representing a departure from the arm's-length standard.

As noted earlier, the withdrawn Ninth Circuit majority opinion in Altera represented an extremely disheartening development for most tax professionals in private practice. The Tax Court's Altera opinion had been viewed as sending a strong message to the IRS and Treasury that what had been the prevailing practice of providing preambles to tax regulations with inadequate explanations of the reasoning supporting the rules adopted in the regulations[17] would no longer be acceptable to the Tax Court and that instead the IRS and Treasury would be held to the same requirements of reasoned decision-making and reasoned explanations that are applicable to the regulations issued by all other federal agencies.

The withdrawn Ninth Circuit majority opinion's reversal of the Tax Court in Altera could be viewed as giving permission to the IRS and Treasury to return to less careful rulemaking practices. Clearly, the withdrawal of the Ninth Circuit's July 24 opinion substantially undercuts the significance of the withdrawn majority opinion. Nevertheless, at a minimum, the withdrawn majority opinion represents the views of Chief Judge Sidney Thomas, the author of that opinion. And until a new opinion is issued, there is at least the possibility that his views will prevail for the panel.

As a result, the District of Columbia Circuit's issuance of its opinion in Good Fortune Shipping provided very welcome good news after the bad news of the Ninth Circuit's majority — now withdrawn — opinion in Altera. Moreover, as will be discussed below, the District of Columbia Circuit opinion, considered on its own, is a significant development in the case law relating to challenges to the validity of tax regulations.

Good Fortune Shipping involved a challenge to the validity of certain provisions under IRC Section 883. Section 883(a) provides that certain categories of gross income earned by a foreign corporation are exempt from income taxation in the U.S. Under Section 883(a)(1), one of those exempted categories of gross income is gross income derived by the foreign corporation from the international operation of a ship or ships if the foreign country in which the corporation is organized grants an equivalent exemption to U.S. corporations. However, this exemption does not apply if 50 percent or more of the value of the stock of the foreign corporation is owned by individuals who are not residents of the foreign country in which the corporation is organized or another foreign country that grants the same type of exemption for international shipping income to corporations that are organized in the U.S.

The provision of the regulations under Section 883 that was challenged in Good Fortune Shipping provided that, for purposes of applying the stock ownership test in Section 883(c)(1), stock that is issued in bearer form does not count. Thus, if all the stock issued by a foreign corporation was issued in bearer form, as was the case for the taxpayer corporation in Good Fortune Shipping, it was not possible for the corporation to satisfy the stock ownership test in Section 883(c)(1), and thus it was not possible for the corporation to obtain the benefit of the gross income exemption in Section 883(a)(1).

The taxpayer in Good Fortune Shipping argued in the Tax Court that this provision in the Section 883 regulations requiring that stock issued in bearer form must be disregarded for purposes of applying the stock ownership test of Section 883(c)(1) violated both step one and step two of the Chevron test for evaluating the validity of regulations. Under Chevron step one, "the question [is] whether Congress has directly spoken to the precise question at issue" and whether "the intent of Congress is clear."[18] "If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."[19] Another way the Chevron opinion formulated the inquiry at step one of the test is whether "Congress has…left a gap for the agency to fill."[20]

Under step two of the Chevron test, "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[21]

As noted above, the taxpayer in Good Fortune Shipping argued in the Tax Court that the provision in the Section 883 regulations requiring that bearer stock be disregarded violated both Chevron step one and Chevron step two. The taxpayer argued that the provision violated Chevron step one because the term "owned" in Section 883(c)(1) has a clear meaning that does not leave any room for a rule that excludes a particular form of ownership of stock, namely, ownership through bearer shares. The IRS argued that since the text of Section 883(c)(1) does not explicitly address the issue of ownership of stock through bearer shares, Chevron step one was not violated.

The Tax Court agreed with the IRS, reasoning that "[t]he words 'owned by individuals' in Section 883(c)(1) do not, as petitioner appears to acknowledge, explain or otherwise address how to establish ownership by individuals for purposes of Section 883(c)(1), let alone how to establish ownership where the shares of the foreign corporation are owned in bearer form."[22]

The taxpayer's argument under Chevron step two was basically the same as its argument under Chevron step one, namely, that the provision in the regulations requiring that stock held in bearer form must be disregarded for purposes of applying the stock ownership test in Section 883(c)(1) is not a reasonable interpretation of the statutory provision because the provision in the regulations is inconsistent with the plain language of the statutory provision.[23] The Tax Court held that this provision in the regulations was reasonable because of the difficulty of establishing the ownership of stock held in bearer form.

The taxpayer did not argue in the Tax Court that this provision in the regulations violated the APA arbitrary and capricious standard or the interpretation of that standard that is set forth in State Farm.

The taxpayer appealed to the District of Columbia Circuit and the District of Columbia Circuit, in a unanimous panel decision, reversed the decision of the Tax Court, reasoning that the issuance of the regulations violated step two of the Chevron test. What makes the District of Columbia Circuit's Good Fortune Shipping decision significant for challenges to the validity of tax regulations far beyond the specific context of the treatment of bearer stock under the stock ownership test in Section 883(c)(1) is the fact that the District of Columbia

Circuit applied Chevron step two in a way that was basically indistinguishable from the reasoned decision-making requirement under the APA's arbitrary and capricious standard and State Farm.

As noted earlier, the Supreme Court in Judulang noted that there was substantial equivalence between Chevron step two and the arbitrary and capricious standard. Moreover, there is a substantial line of cases in the District of Columbia Circuit making clear that there is, at a minimum, considerable overlap between Chevron step two and the arbitrary and capricious standard.[24]

However, most courts that have applied the Chevron two-step test have applied Chevron step two in a way that evaluates only whether the result of the agency's decision-making process was reasonable and not whether the decision-making process itself was reasoned.[25] Consequently, for a District of Columbia Circuit opinion in a case involving a challenge to the validity of a tax regulation to apply Chevron step two as incorporating a reasoned decision-making requirement represents a substantial expansion of the case law relating to challenges to the validity of tax regulations.

Moreover, as noted earlier, the District of Columbia Circuit is uniformly recognized as being the circuit with by far the most expertise and experience in dealing with administrative law issues. While the Ninth Circuit also hears a considerable number of administrative law cases, most of those cases involve environmental issues. In contrast, the District of Columbia Circuit hears cases involving the full range of federal administrative agencies. Moreover, because administrative law cases represent such a large proportion of the District of Columbia Circuit's case load, it has the opportunity to see many instances in which federal agencies have fallen short in the administrative process involved in making decisions that affect the public and therefore may be somewhat less deferential to actions by federal administrative agencies than other circuits.

Turning to some of the detail in the District of Columbia Circuit decision in Good Fortune Shipping, the court began its discussion by describing the inquiry under Chevron step two in a way that essentially equated Chevron step two with the reasoned decision-making standard under the APA arbitrary and capricious test:

Our focus is…on "whether the [agency] has reasonably explained how the permissible interpretation it chose is 'rationally related to the goals of' the statute."[26]

While the foregoing quotation is a statement of the applicable standard of review rather than a specific application of that standard in the particular circumstances of the case, nevertheless, the court's application of that standard was entirely consistent with the general standard:

Even if Section 883 grants the IRS significant discretion to establish how to prove ownership, it hardly authorizes the agency to categorically deny consideration of a recognized form of ownership based on only a single, undeveloped statement that it is 'difficult[]' to reliably track the location of a given owner.[27]

Moreover, the court also referred to several circumstances relating to the treatment of bearer shares under the challenged regulation as representative of the type of unexplained inconsistency that is a frequent characteristic of what courts generally find to be arbitrary and capricious decision-making. In this regard, the court identified the unexplained inconsistency between the treatment of bearer shares for this purpose and the more accommodating treatment of other forms of ownership that also involve issues in determining the identity of the owner, as well as the unexplained inconsistency between the treatment of bearer shares for this purpose and the more accommodating treatment of bearer shares under other provisions of the Internal Revenue Code. In addition, while the court's analysis emphasized the fact that the position taken in the challenged regulation with respect to bearer shares represented an unexplained change in position from the prior treatment of bearer shares in a revenue procedure, nevertheless, as the court's discussion makes clear, such a change in position is clearly not a necessary element that must be present in order for a court to conclude that the reasoned decision-making standard has been violated.

As noted above, the District of Columbia Circuit's application of the reasoned decision-making standard in invalidating the challenged regulation provision relating to the treatment of bearer shares under Section 883 provides a very welcome addition to the body of case law relating to challenges to the validity of tax regulations.

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[1] Altera Corp. v. Commissioner, Nos. 16-70496, 16-70497 (9th Cir. July 24, 2018). My law firm and I have done work for Altera in the past, but, at the present time, there is no relationship of any kind between Altera or Intel Corporation, Altera's current parent corporation, and me or my law firm.

[2] Altera Corp. v. Commissioner, 145 T.C. 91 (2015).

[3] Good Fortune Shipping SA v. Commissioner, No. 17-1160 (D.C. Cir. July 27, 2018), rev'g 148 T.C. No. 10 (March 28, 2017).

[4] 5 U.S.C. § 706(2)(A).

[5] Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29 (1983).

[6] Id. at 52.

[7] Id. at 43.

[8] Id. at 48-49 (citations omitted).

[9] Id. at 50.

[10] SEC v. Chenery, 318 U.S. 80 (1943) ("Chenery I"); SEC v. Chenery, 332 U.S. 194 (1943) ("Chenery II").

[11] 463 U.S. at 50.

[12] Id. at 43.

[13] Chevron USA Inc. v. Natural Resources Defense Council Inc, 467 U.S. 837 (1984).

[14] Judulang v. Holder, 565 U.S. 42, 52 n.7 (2011).

[15] The only respect in which I believe the Tax Court opinion in Altera was disappointing was the court's acceptance of the IRS position that a reviewing court must choose between applying Chevron and applying the arbitrary and capricious standard in a case involving a challenge to the validity of a regulation. To the contrary, it is clear that when the validity of a regulation is being challenged, both standards must be applied, and both standards must be satisfied in order for the challenged regulation to be upheld. See, e.g., Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2125 (2016) (explaining that it must be determined that the agency satisfied the arbitrary and capricious standard in issuing a regulation before the reviewing court may proceed to an application of the Chevron two-part test).

[16] 145 T.C. at 118-19.

[17] As noted in the Tax Court opinion, the Internal Revenue Manual had until very recently stated that it was not necessary for the preambles to tax regulations to justify the rules adopted or proposed in the regulations. See 145 T.C. at 116.

[18] 467 U.S. at 842.

[19] Id. at 843 n.9.

[20] Id. at 843.

[21] Id.

[22] 148 T.C. at 32.

[23] Id. at 33.

[24] See, e.g., Shays v. FEC, 414 F. 3d 76, 96-97 (D.C. Circuit 2005)

[25] The Chevron opinion itself said nothing about any need to satisfy the reasoned decison-making requirement in its description of step two of the two-part test, although later in the opinion, in explaining why the agency's result was reasonable, the Court noted that "the agency considered the matter in a detailed and reasoned fashion," as one of the factors supporting that conclusion, although it did not cite State Farm or the arbitrary and capricious standard in support of the relevance of that factor. 467 U.S. at 865.

[26] Slip op. at 8.

[27] Slip op. at 10.