taxnotes federal

Volume 164, Number 12 ■ September 16, 2019

Ninth Circuit Grapples With Agency Positions First Raised in Litigation

by George M. Gerachis, David C. Cole, and Juliana D. Hunter

Reprinted from *Tax Notes Federal*, September 16, 2019, p. 1889

Ninth Circuit Grapples With Agency Positions First Raised in Litigation

by George M. Gerachis, David C. Cole, and Juliana D. Hunter

George M. Gerachis

David C. Cole

Juliana D. Hunter

George M. Gerachis and David C. Cole are partners and Juliana D. Hunter is counsel at Vinson & Elkins LLP.

In this article, the authors discuss two recent cases that question how much weight courts should give an agency's position that is first raised in litigation.

Summary

In two recent cases, *Amazon.com*[1] and *Altera*,[2] different Ninth Circuit panels issued important decisions involving cost-sharing arrangements. Underlying these cases is a more fundamental issue: How much weight should courts give an agency's position that is first raised in litigation? Because the two decisions approach the question in ways that are hard to reconcile, a rehearing of *Altera* by the full Ninth Circuit is warranted.

In *Altera*, decided by a three-judge panel June 7, the court addressed whether related entities must share the cost of employee stock compensation under qualified cost-sharing arrangements, with the majority deferring to Treasury regulations that require such costs to be included in a cost-sharing arrangement. On August 16 a different three-judge panel in *Amazon.com* analyzed whether "residual-business assets" — such as goodwill, going concern, workforce in place, and a "culture of innovation" — must be included in the valuation of preexisting intangibles for purposes of a cost-sharing arrangement buy-in payment. The *Amazon.com* court concluded that residual business assets were not intangibles under the then-applicable regulation,[3] in part because it was ambiguous and Treasury failed to give taxpayers fair notice of its interpretation.

Beyond their impact on cost-sharing arrangements, these cases are noteworthy for their differing approaches to agency positions first announced in litigation. The two-judge majority in *Altera* approved a statutory interpretation that according to the dissent was put forth by Treasury for the first time in appellate briefs as a justification for the regulation at issue. Just over two months later, the *Amazon.com* panel (citing *Kisor*,[4] a Supreme Court case decided after *Altera*)

[1] *Amazon.com v. Commissioner*, No. 17-72922 (9th Cir. 2019).

[2] *Altera v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019).

[3] *Amazon.com* addressed the interpretation of reg. section 1.482-4(b) as promulgated in 1994 and 1995, which was superseded by temporary regulations issued in 2009. *See Amazon.com*, No. 17-72922 at n.1.

[4] *Kisor v. Wilkie*, 139 S. Ct. 2400 (2019).

held that when an agency first announces a regulatory interpretation in court briefs, the interpretation is entitled to no deference.

These two cases confuse the state of the law on whether agency interpretations first announced as litigating positions are entitled to any weight in the Ninth Circuit. Given the Supreme Court's trend toward a more critical analysis of an agency's rulemaking interpretations, the Ninth Circuit should agree to rehear the *Altera* decision en banc.

Judicial Review of Agency Rulemaking

Courts evaluate the validity of an agency's regulations under two fundamental Supreme Court precedents: *Chevron*[5] and *State Farm*.[6] *Chevron* requires a two-step analysis in determining whether an agency's interpretation of a statute is reasonable. First, the court asks whether the intent of Congress is clear.[7] If the statute is silent or ambiguous, the court moves on to the second step of *Chevron*: whether the agency's interpretation is a permissible construction of the statute. Deference is appropriate unless the regulation is "arbitrary, capricious, or manifestly contrary to the statute."[8] Under *State Farm*, an agency must engage in "reasoned decisionmaking" to avoid a finding that its regulation is arbitrary and capricious.[9] This framework of judicial analysis works side by side with the Administrative Procedure Act (APA),[10] which requires that an agency give notice of its proposed rules and allow for full participation by interested parties.[11] Deference is not warranted when the regulation is "procedurally defective."[12]

The Supreme Court expanded on *Chevron* second step deference in *Auer*,[13] requiring deference to an agency's interpretation of its own ambiguous regulation unless the interpretation is "plainly erroneous or inconsistent with the regulation."[14] However, in a series of recent cases capped by *Kisor*, decided June 26, 2019, the Supreme Court has shown an increasing reluctance to defer to an agency's interpretation of its regulations.[15] *Kisor* reiterated several factors that limit judicial deference to an agency's interpretation of its regulations. Significantly, the Court confirmed that courts "should decline to defer to a merely 'convenient litigating position,' a '*post hoc* rationalizatio[n] advanced' to 'defend past agency action against attack,'" or "to a new interpretation, whether or not introduced in litigation, that creates 'unfair surprise' to regulated parties."[16]

Altera v. Commissioner

At issue in *Altera* was the validity of reg. section 1.482-7A(d)(2), which requires related business entities to share the cost of employee stock compensation under a qualified cost-sharing arrangement. The parties did not dispute that the regulation is clear. Rather, the issue was whether the regulation was a valid interpretation of the statute, section 482. The Tax Court had invalidated the regulation, holding that an analysis of comparable transactions is required under the arm's-length standard of section 482, and that there was no evidence that unrelated parties shared stock-based compensation expenses. The Ninth Circuit panel reversed. Significantly, the panel agreed with Treasury's position that to achieve arm's-length results, the agency can do away with comparable transactions in favor of a commensurate with income analysis — that is, an analysis based purely on internal transactions.[17]

[5] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

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

[7] *Chevron*, 467 U.S. at 842-843.

[8] *Id.* at 844.

[9] *State Farm*, 463 U.S. at 52.

[10] *See Kisor*, 139 S. Ct. at 2423.

[11] *See* 5 U.S.C. section 553.

[12] *Encino Motorcars LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016).

[13] *Auer v. Robbins*, 519 U.S. 452 (1997).

[14] *Id.* at 461 (quoting *Robertson v. Methow Valley Citizens Council*, 490 U.S. 332, 359 (1989)).

[15] *See, e.g., Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142 (2012) (declining to defer to an agency's interpretation of its own regulation when it was first put forth in briefs in the case). Justice Clarence Thomas, dissenting from a denial of certiorari in *United Student Aid Funds Inc. v. Bible*, 136 S. Ct. 1607, 1608 (2016), wrote, "Any reader of this Court's opinions should think that the [*Auer*] doctrine is on its last gasp."

[16] *Kisor*, 139 S. Ct. at 2417-2418 (citations omitted).

[17] *Altera*, 926 F.3d 1061.

The crux of the Ninth Circuit's opinion on this issue focused on the taxpayer's argument that Treasury, by claiming for the first time in litigation that the arm's-length standard does not require analysis of comparable transactions, failed to give sufficient notice and an opportunity to participate to interested persons. On this point, the panel concluded that the arm's-length standard has historically been "fluid" so that Treasury's interpretation of the standard was merely a clarification of the position it has taken all along: that comparable transactions are required only when they exist.[18]

Many tax practitioners regard the government's argument (and the panel's holding) in *Altera* as a significant change in the application of the arm's-length standard. But the most noteworthy part of the majority's decision might be its acceptance of Treasury's novel statutory interpretation raised for the first time in Treasury's appellate briefs. In her dissent, Judge Kathleen M. O'Malley, a Federal Circuit judge sitting by designation, noted that regardless of whether Treasury was correct that it could jettison the arm's-length standard in favor of the internal commensurate with income standard (which the dissent described as a stark departure from Treasury's previous position),[19] the APA requires Treasury to articulate the basis for its action and give interested persons notice and an opportunity to comment.[20] Instead, Treasury's new justification for the regulation — that section 482 does not require a comparability analysis — was first set forth in its appellate briefs.[21] In O'Malley's view, this violated *State Farm*'s reasoned decision-making standard and the fair warning requirement of the APA.

Amazon.com v. Commissioner

In the more recently decided case of *Amazon.com*, a different three-judge panel of the Ninth Circuit held that when the commissioner first announces a regulatory interpretation in court briefs, the interpretation is entitled to no deference. At issue in *Amazon.com* was the correct method for valuing preexisting intangibles under the then-applicable transfer pricing regulations. The IRS increased Amazon's taxable income by including residual business assets in the buy-in payment, such as Amazon's culture of innovation, the value of workforce in place, going concern value, goodwill, and growth options. In a 3-0 decision, the panel rejected Treasury's interpretation of reg. section 1.482-4(b), finding that the definition of intangible is limited to independently transferable assets and that Treasury's interpretation of the regulation was not entitled to deference.[22]

Unlike *Altera*, in *Amazon.com* the regulation itself was unclear (specifically, as to whether residual business assets should be treated as "other similar items" to a list of specified intangibles for purposes of section 482[23]). The *Amazon.com* panel rejected the commissioner's argument that the court owed *Auer* deference to the regulation, citing *Kisor* for the rule that courts need not defer to an agency's interpretation when the agency failed to give regulated parties fair warning of the required conduct.[24] The timing of Treasury's first announcement of its interpretation (in court briefs in the case) was dispositive to the court, which reasoned that agency interpretations first explained in enforcement proceedings create unfair surprise to regulated parties.[25]

Comparison of *Altera* and *Amazon.com*

In both *Altera* and *Amazon.com*, Treasury seems to have raised an interpretation for the first time as part of its litigating position. In *Amazon.com*, the panel held that doing so violated requirements of procedural fairness. The *Altera* majority, however, did not discuss this issue directly, instead excusing Treasury's post hoc

[18] *Id.* at 1083.

[19] *Id.* at 1096.

[20] *Id.* at 1096-1097.

[21] *Id.* at 1092. The commissioner justified its arguments on appeal as a clarification of prior policy that its analysis was consistent with an arm's-length standard, but as the dissent pointed out, Treasury's argument that section 482 no longer requires a comparability analysis was a new one.

[22] *See Amazon.com*, No. 17-72922.

[23] Reg. section 1.482-4(b)(6). *Amazon.com* was governed by regulations issued in 1994 and 1995. Treasury issued new temporary cost-sharing regulations in 2009 that replaced the 1994/1995 regulations, and in 2017 Congress amended the definition of intangible property as part of the Tax Cuts and Jobs Act. *See* 74 *F.R.* 340 (Jan. 5, 2009) and P.L. 115-97, section 14221(a), 131 Stat. 2054, 2218 (2017).

[24] *Amazon.com*, No. 17-72922.

[25] *Id.*

rationalization by finding that Treasury's position was a clarification rather than an alteration of prior policy. Under the reasoning of *Amazon.com*, however, the statutory interpretation first put forward by Treasury in *Altera* appellate briefs — that comparable transactions are not required for an arm's-length analysis — would seem to violate the APA's requirement that interested persons be given fair warning and an opportunity to participate in an agency's rulemaking process. However "fluid" the arm's-length standard, the IRS's abandonment of considering how unrelated parties act could not reasonably have been anticipated by taxpayers.

Amazon.com's more recent pronouncement indicates a reluctance by some Ninth Circuit judges to simply defer to an agency's interpretation put forth as a litigating position without more critical analysis. *Kisor* reflects the Supreme Court's similarly more critical evaluation of an agency's rulemaking process and a significant narrowing of *Auer* deference, including when the agency's interpretation is part of a "convenient litigating position." While *Amazon.com* and *Kisor* both involved the issue of judicial deference toward an agency's interpretation of an ambiguous regulation, rather than the validity of an agency's regulation concerning an ambiguous statute as in *Altera*,[26] procedural fairness — and rulemaking transparency — is owed to taxpayers in either instance. Whether the analysis is one of reasoned decision-making under *State Farm*, fair notice and opportunity to participate under the APA, or deference to an agency's interpretation of its ambiguous regulation within the narrow confines of *Auer*, the current standard in the Ninth Circuit is murky at best.

Even were it inclined to do so, the Ninth Circuit may have difficulty reconciling *Altera* and *Amazon.com* by giving Treasury more leeway in interpreting an ambiguous statute as opposed to an ambiguous regulation: The regulatory definition at issue in *Amazon.com* was taken almost directly from a statute. During the years at issue in *Amazon.com*, the definition of intangible in reg. section 1.482-4(b)(1)-(5) was essentially copied from the relevant statutory definition in section 936(h)(3)(B)(i)-(v).[27] Thus, in analyzing Treasury's interpretation of the regulation, the Ninth Circuit was effectively analyzing Treasury's interpretation of a statute. Would the Ninth Circuit have reached a different holding in *Amazon.com* if Treasury had simply cross-referenced the statutory definition of intangible in section 936 rather than copying that language into the section 482 regulation, and, if so, under what rationale?

These issues and concerns regarding the weight afforded to agency interpretations and the need for transparency in those interpretations implicate not only Treasury regulations but all federal regulations. These broad implications warrant a closer look at *Altera* in a rehearing by the full Ninth Circuit. ■

[26] As part of his *Kisor* concurrence, Chief Justice John G. Roberts Jr. was careful to note that the case involved the standard of deference owed to an agency's interpretation of its own unclear regulation, known as *Auer* deference, which he viewed as distinct from the issue of judicial deference to agency interpretations of statutes enacted by Congress.

[27] The section 936 definition is the relevant statutory definition because of the cross-reference to section 936 in section 482 itself.