



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

July 7, 2008

Hon. Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Supplemental Comments on Proposed Regulations Under Sections 6011 and 6111 of the Internal Revenue Code relating to Patented Transactions (REG-129916-07)

Dear Commissioner Shulman:

Enclosed are supplemental comments on proposed regulations under sections 6011 and 6111 of the Internal Revenue Code relating to reporting of tax strategy patent transactions. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Anita Soucy, Attorney-Advisor, Department of the Treasury

CHAIR

Stanley L. Blend
San Antonio, TX

CHAIR-ELECT

William J. Wilkins
Washington, DC

VICE CHAIRS

Administration

Rudolph R. Ramelli
New Orleans, LA

Committee Operations

Elaine K. Church
Washington, DC

Communications

Ellen P. Aprill
Los Angeles, CA

Government Relations

Armando Gomez
Washington, DC

Professional Services

Samuel L. Braunstein
Fairfield, CT

Publications

Louis Mezzullo
Rancho Santa Fe, CA

SECRETARY

Alice G. Abreu
Philadelphia, PA

ASSISTANT SECRETARY

Walter Burford
Atlanta, GA

COUNCIL

Section Delegates to the

House of Delegates

Paul J. Sax
San Francisco, CA

Richard M. Lipton
Chicago, IL

Immediate Past Chair

Susan P. Serota
New York, NY

MEMBERS

Christine L. Agnew
Houston, TX

John P. Barrie
New York, NY

Peter P. Blessing
New York, NY

Peter J. Connors
New York, NY

Richard S. Gallagher
Milwaukee, WI

Sharon Stern Gerstman
Buffalo, NY

C. Wells Hall
Charlotte, NC

Helen M. Hubbard
Washington, DC

Kathryn Keneally
New York, NY

Emily A. Parker
Dallas, TX

Priscilla E. Ryan
Chicago, IL

Stephen E. Shay
Boston, MA

Barbara Spudis de Marigny
San Antonio, TX

LIAISON FROM ABA

BOARD OF GOVERNORS

Raymond J. Werner
Chicago, IL

LIAISON FROM ABA

YOUNG LAWYERS DIVISION

Matthew McLaughlin
Gulfport, MS

LIAISON FROM LAW

STUDENT DIVISION

Venay Kumar Puri
Pittsburgh, PA

DIRECTOR

Christine A. Brunswick
Washington, DC

**SUPPLEMENTAL COMMENTS CONCERNING PROPOSED REGULATIONS
UNDER SECTIONS 6011 AND 6111 OF THE INTERNAL REVENUE CODE
RELATING TO PATENTED TRANSACTIONS**

The following supplemental comments (“Comments”) concerning proposed regulations relating to patent transactions are submitted on behalf of the American Bar Association Section of Taxation (“Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Dennis B. Drapkin and Ellen P. Aprill of the Section’s Task Force on Patenting of Tax Strategies (the “Task Force”). Substantive contributions were made by Linda Beale, Charles H. Egerton, Michael Lang, William M. Paul, Charles A. Pulaski and Andrew A. Schwartz. The Comments were reviewed by William J. Wilkins of the Section’s Committee on Government Submissions, and Stanley L. Blend, Council Director for the Task Force.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact persons:

Dennis B. Drapkin
Tel: 214-969-4850
Email: dbdrapkin@jonesday.com

Ellen P. Aprill
Tel: 213-736-1157
Email: ellen.aprill@lls.edu

Date: July 7, 2008

EXECUTIVE SUMMARY

These supplemental Comments are submitted in response to the request for comments contained in the preamble to Proposed Regulation sections 1.6011-4 and 301.6111-3¹ (the “Proposed Regulations”) as published in the Federal Register on September 26, 2007.² The Proposed Regulations would add a new category of reportable transactions for patented transactions and make conforming changes to the rules relating to disclosures of reportable transactions by material advisors.

These Comments make the following recommendations:

- That certain reporting parties be permitted to elect an alternative reporting method in place of the otherwise applicable tax strategy reporting system of the Proposed Regulations.
- That the definition of “tax planning method” in the Proposed Regulations be clarified and narrowed in certain respects.
- That a number of miscellaneous technical changes be made, including (a) revisions relating to the definition of “fee,” “patent holder,” “related parties,” and “patented transactions,” (b) expansion of reporting to non-income taxes, and (c) clarification of the Proposed Regulations in the case of certain business transactions.
- That Circular 230 be revised in certain respects and that comments be invited on a number of issues relating to the application of Circular 230 to tax strategy patents.

¹ Unless otherwise indicated, all references to a “section” is to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and all references to Regulations are to the Treasury Regulations promulgated under the Code.

² 72 Fed. Reg. 54615 (Sept. 26, 2007).

DISCUSSION

1. **Background**

The Section has previously submitted comments (the “Prior Comments”) in response to the Proposed Regulations.³ A public hearing on the Proposed Regulations was held on February 21, 2008 (the “Hearing”), and the Section presented testimony at the Hearing. The Section submits these Comments in response to a number of issues raised at the Hearing and in other submissions made in connection with the Proposed Regulations.

2. **Alternative system of reporting**

For the reasons discussed below, we recommend that certain reporting parties be permitted to elect an alternative reporting method in place of the otherwise applicable tax strategy patent reporting system contemplated by the Proposed Regulations. We believe that in most instances, this alternative will provide relevant information in a timely manner while reducing and often eliminating burdensome reporting that would be of limited interest to the Internal Revenue Service (“IRS”) and the Department of the Treasury (“Treasury Department”).

Specifically, we recommend that in lieu of the generally applicable Proposed Regulation section 1.6011-4 patented transaction reporting obligations, the taxpayer may provide to the IRS, at the time the patent application is filed, a submission that includes the following information: a summary of the invention disclosed in the application, a description of the patent claims that relate to tax matters and how such claims purport to affect tax liability, and a description of the tax consequences discussed in the patent application that relate to the invention disclosed in the application. Under this approach, the taxpayer would be required to update the submission periodically upon certain events (perhaps within 30 days), including upon the filing of any

³ ABA Section of Taxation, Comments Concerning Proposed Regulations Under Sections 6011 and 6111 of the Internal Revenue Code Relating to Patented Transactions, available at <http://www.abanet.org/tax> (January 29, 2008).

amendments and modifications to the patent application, the withdrawal of the patent application (or of any claims), and the grant of the patent. Finally, the taxpayer would be required to certify to the IRS that it will prominently disclose, or cause to be prominently disclosed, in all written communications pertaining to the patent a notice stating that the issuance of a patent in respect of a tax planning method by the U.S. Patent and Trademark Office does not constitute IRS or Treasury Department approval of any tax statement made in the patent or patent application, and that the issuance of a patent does not preclude the IRS or Treasury Department from challenging any tax statement made, or tax position taken in accordance with, the patent. If the taxpayer complies in a timely manner with each of the foregoing requirements, then, upon the grant of the patent, any reporting obligations with respect to the patent applicable to any reporting obligations imposed directly or indirectly by section 6011 on any participant with respect to the patent, including obligations under sections 6111 and 6112, will be deemed satisfied. The IRS could in addition reserve the right to override such deemed compliance by notifying the taxpayer within a reasonable period, such as 90 days after the date of grant of the patent, that the taxpayer must comply with the tax patent reporting requirements. We note in this regard, however, that the IRS could instead designate a specific patented tax strategy transaction as a listed transaction or a transaction of interest. *See* Regulations sections 1.6011-4(b)(2) and 1.6011-4(b)(6).

It appears that, to date, many tax strategy patents and published tax strategy patent applications involve straightforward, common-sense interpretations and applications of the tax law that are not abusive.⁴ In those cases, the primary interest of the IRS and Treasury Department will be to acquire information, preferably well in advance, about potential assertions

⁴ This observation is made solely from a tax law perspective. No inference is intended regarding whether the requirements for patentability have been satisfied. We have previously expressed our general concerns with tax strategy patents. *See* Prior Comments at 4-5.

of monopoly-like control by private parties over parts of the tax law so that appropriate action can be considered. Requiring tax strategy patent applicants to report to the IRS at the time they submit their patent applications serves this purpose. Additional reporting of the implementation of that monopoly-like control after the grant of the patent does not appear to warrant the resulting burdens imposed on taxpayers. Because the patent examination process ordinarily takes a minimum of several years, obtaining information through the proposed alternative reporting method will provide the IRS with adequate time in which to review the reported information and decide whether post-patent grant reporting is needed. In addition, as stated in the Preamble to the Proposed Regulations, the IRS and the Treasury Department are concerned that a patent on tax advice or a tax strategy could be interpreted by taxpayers as approval by the IRS and Treasury Department of the transaction.⁵ Accordingly, we believe that the proposed alternative reporting method will better align tax strategy reporting burdens with the interests of the IRS and Treasury Department and that the proposed certification will help alleviate the concern that taxpayers will interpret the grant of a tax strategy patent as constituting approval by the IRS and the Treasury Department of the transaction.

We considered the alternative of requiring post-grant reporting unless the IRS affirmatively notified the taxpayer to the contrary. This approach, however, is inconsistent with the observations noted above, which suggest that post-grant reporting will not often be of particular benefit to the IRS and Treasury Department. Therefore, given the likelihood that post-grant reporting will not be as useful, we determined that the alternative reporting method should default as proposed above, *i.e.*, no required post-grant reporting, rather than the other way around.

⁵ 72 Fed. Reg. 54615, 54615 (Sept. 26, 2007).

An additional advantage of this proposal is that it may address concerns that have been expressed regarding the threshold definition of “tax planning method.” Proposed Regulation section 1.6011-4(b)(7)(ii)(F). If, as we anticipate, the IRS will infrequently request reporting beyond the grant of a patent, taxpayers may view the proposed reporting alternative as a reasonable protective measure, the compliance costs of which are not unduly burdensome.

Finally, as with the Proposed Regulations, our proposal may be implemented under existing provisions of the Code. Alternative reporting methods that have been suggested by other commentators, in our view, may require either implementation under or amendments to the Patent Code, 35 U.S.C. §§ 1 *et seq.*⁶

3. Definition of “tax planning method”

The Proposed Regulations would add “patented transactions” to the list of reportable transactions under Regulations section 1.6011-4. A “patented transaction” is defined as one in which a taxpayer pays a fee for the right to use a “tax planning method that ... is the subject of [a] patent.”⁷ “Tax planning method” is defined as “any plan, strategy, technique, or structure designed to affect Federal income, estate, gift, generation skipping transfer, employment, or excise taxes,” but expressly excludes “tax preparation software” and other similar “mathematical” or “mechanical” tools for preparing tax returns.⁸ It is unclear whether the proposed definition of “tax planning method” imposes an objective or subjective standard and whether it brings within its scope patents that in our view should not concern the IRS. We

⁶ See letter dated March 2, 2007, from American Institute of Certified Public Accountants at p. 10, and letter dated May 14, 2008, from American College of Trust and Estate Counsel at pp. 7-8.

⁷ Prop. Reg. § 1.6011-4(b)(7)(i).

⁸ Prop. Reg. § 1.6011-4(b)(7)(ii)(F).

therefore recommend certain revisions to this definition to better achieve the goals of the Proposed Regulations.

First, the phrase “designed to affect ... taxes” is ambiguous. It is unclear whether the rule turns on the inventor’s subjective intent while designing the patented process or on the objective nature of the patented process itself. An objective standard is preferable because it will be easier to administer than a subjective standard.

Second, the definition of “tax planning method” appears to bring within the scope of the reporting requirement patents on inventions that bear at most only a tenuous or indirect relationship to tax matters. Consider for example technologies that are the subject of special tax credits or deductions, such as “hybrid” motor vehicles that may be eligible for a tax credit.⁹ Numerous patents on hybrid processes, systems and techniques have been issued to date,¹⁰ and many of these may be characterized as “designed to affect” the tax liability of the person who buys a hybrid car. But patents related to hybrid vehicles should not be treated as tax strategy patents for these reporting purposes. Similarly, many business method patents may have an insignificant tax component that contributes to, but does not determine the usefulness of, the patent. These are not the type of tax strategy patents that should be targeted by the Proposed Regulations. The definition of “tax planning method” should therefore be revised to exclude patents on technological or business method inventions having only an incidental effect on taxes.

Accordingly, to address these concerns, we suggest that the Treasury Department and IRS consider replacing the phrase “designed to affect” in the definition of tax planning method with language along the lines of “whose usefulness is more than incidentally derived from its

⁹ See I.R.C. § 30B(d).

¹⁰ A search of the United States Patent & Trademark Office’s patent database (www.uspto.gov) conducted on May 23, 2008, for issued patents with the words “hybrid” and “vehicle” in their title yielded 851 results.

expected effect on”. This change implies a test that is more objective than subjective. It also tends to exclude inventions that have only an incidental effect on taxes. The usefulness of a plan, strategy, technique or structure should be considered more than incidentally derived from the expected tax effect if the plan, strategy, technique or structure, taken as a whole, would not be workable absent the expected tax effect.

4. Miscellaneous technical comments

a. Definition of “fee” in Proposed Regulation section 1.6011-4(b)(7)(ii)(A). The last sentence of this paragraph excludes from the definition of “fee” “... amounts paid in settlement of, or as the award of damages in, a suit for damages for infringement of the patent.” The word “claim” should be substituted for the word “suit” in this sentence. Generally, any action initiated against a patent infringer will be commenced by a letter or telephone call from the attorney for the patent holder threatening the filing of a suit unless an appropriate fee is paid. Many times the user may opt for a negotiated arrangement, including a fee, rather than incur the expense and aggravation associated with defending a lawsuit. In such case, a payment in settlement of the claim would be made. If the term “suit” is interpreted literally, such a settlement payment would not be protected by the last sentence and would, thus, be treated as a “fee.” Consequently, the substitution of the word “claim”, perhaps coupled with a parenthetical such as “(whether or not suit was initiated)”, would more appropriately carry out the intent of this sentence. For the same reasons, similar changes should be made in the last sentence of the definition of “payment” in Proposed Regulation section 1.6011-4(b)(7)(ii)(E).

b. Definition of “patent holder” in Proposed Regulation sections 1.6011-4(b)(7)(ii)(C)(3) and (4). Both of these paragraphs refer to the transfer (in the case of paragraph (3)) or receipt (in the case of paragraph (4)) of “all substantial rights to the patent.” For purposes of Proposed Regulation section 1.6011-4(b)(7)(i) (definition of patented transaction), however,

there does not appear to be any reason to exclude from the definition of “patent holder” a person who receives under these circumstances an undivided interest (as defined in Regulation section 1.1235-2(c)) in all substantial rights to a patent. We recommend that this change be made, perhaps with a de minimis exception.

c. Significance of “related parties” in Proposed Regulation section 1.6011-4(b)(7)(iii). Proposed Regulation section 1.6011-4(b)(7)(iii) provides that certain related parties will be treated as the same person for purposes of Proposed Regulation section 1.6011-4(b)(7). The significance of this rule is not clear. The rule may mean that payments among related parties will be disregarded for purposes of determining whether a patented transaction has occurred (Proposed Regulation section 1.6011-4(b)(7)(i)); that transfers of patent rights among related parties will be disregarded in determining whether a person is a patent holder (Proposed Regulation section 1.6011-4(b)(7)(ii)(C)); or possibly some other result. Accordingly, this part of the Proposed Regulations would benefit from clarification.

d. Definition of “patented transactions” in Proposed Regulation section 1.6011-4(c)(3)(i)(F). The term “tax benefit” should be clarified to indicate that it includes adjustments to basis resulting from the capitalization of fees and expenses associated with filing for patent protection. In addition, the last sentence of the definition contains two references to a tax return that “reflects a tax benefit” or “reflects income”. In order to prevent a patent holder from avoiding the application of the Proposed Regulations by simply failing to include income or to claim a tax benefit that is otherwise available, this language should be changed to “reflects or is permitted or required to reflect”. Note in this regard that the definition of “tax benefit” in Regulation section 1.6011-4(b)(6) is likely premised on the assumption that a tax benefit resulting from a transaction is desirable. In the context of these Proposed Regulations, however,

the possibility of a tax benefit may be viewed as undesirable because it may trigger reporting obligations even though such tax benefit is not itself the reason for undertaking the transaction.

e. Application of reporting requirements to non-income taxes. The proposed definition of “tax planning method”¹¹ refers to federal income, estate, and other taxes. However, because Regulations sections 1.6011-4(c)(5) through -4(c)(9) are not proposed to be amended, it appears that the Proposed Regulations will apply to non-income tax planning strategies only based on fees paid and/or received, but not upon the filing of tax returns reporting tax benefits from implementing the strategies.¹² Therefore, unlike federal income tax planning methods, the derivation of benefits from other federal taxes will not be separate tax patent strategy reporting events. Further amendments are needed to give such reporting effect to the intended scope of “tax planning method.”

f. Business transactions involving tax strategy patents. Intellectual property rights, including patents and patent licenses, are often transferred, both directly in asset transactions and indirectly in entity transactions. The focus of the Proposed Regulations should be on the development and exploitation of tax strategy patents. The Proposed Regulations should, therefore, be amended to make clear that certain business transactions involving tax strategy patents and related rights do not result in reporting obligations under these Regulations, when finalized.

5. Application of Circular 230 to tax strategy patents

There are a number of issues that may arise under the rules governing practice before the IRS as set forth in 31 C.F.R. part 10 (“Circular 230”) in connection with tax strategy patents,

¹¹ Prop. Reg. § 1.6011-4(b)(7)(ii)(F).

¹² Compare (for listed transactions and transactions of interest): Reg. §§ 20.6011-4 (estate tax); 25.6011-4 (gift tax); 31.6011-4 (employment taxes); 53.6011-4 (foundation excise taxes); 54.6011-4 (pension excise taxes); and 56.6011-4 (public charity excise taxes).

including written communications between patent holders (or their agents) and patent users in respect of tax strategy patents. This portion of the Comments describes the issues and makes recommendations for possible revisions to Circular 230. In addition, we recommend that the Treasury Department and the IRS publish a notice about the potential applicability of Circular 230 to tax strategy patents when the Proposed Regulations are finalized.

a. Potential application of the written opinion requirements of Circular 230.

Circular 230 defines “practice before the Internal Revenue Service” to include “rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion”.¹³ The preamble to the final Circular 230 regulations issued in September 2007 further stated that “the rendering of written advice is practice before the Internal Revenue Service subject to Circular 230 when it is provided by a practitioner.”¹⁴ The definition of “practitioner” in Section 10.3(a) makes it clear that attorneys and certified public accountants (CPAs) who render written tax advice that is governed either by the “covered opinion” rules of Section 10.35 or by the “other written opinion” rules of Section 10.37 are considered to be “practicing before the Internal Revenue Service.” The following discussion assumes that the written advice in question (*e.g.*, within a patent license) has been provided by a practitioner.

(i) Licensing agreements. Many tax strategy patents include statements regarding the efficacy of the patented strategy for realizing certain tax benefits. Licensing agreements between patent holders (or their agents) and patent users may include statements regarding the tax consequences resulting from use of the patented tax strategy or may incorporate by reference the statements of tax consequences set forth in the tax patent. Accordingly, we

¹³ 31 C.F.R.. § 10.2(a)(4).

¹⁴ 72 Fed. Reg. 54540, 54541 (Sept. 26, 2007).

believe that tax strategy patent licensing agreements may fall within the Circular 230 definition of “practice before the Internal Revenue Service” to the extent the tax advice is provided by a practitioner and that the licensing agreements may be opinions subject to either the “covered opinion” rules or the “other written opinion” rules.

Circular 230 provides two sets of rules regarding written tax opinions: Section 10.35 (covered opinions) and Section 10.37 (other written opinions). Covered opinions include opinions in respect of listed (or similar) transactions; transactions with a principal purpose of tax avoidance; and transactions with a significant purpose of tax avoidance if they satisfy the requirements of “reliance” opinions or “marketed” opinions or if certain other factors are present. Reliance opinions are tax opinions that are offered at a “more likely than not” confidence level and fail to include a disclaimer stating that they cannot be used to avoid penalties. Marketed opinions are opinions that the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting or marketing a plan or transaction to one or more taxpayers. Such opinions are required to conclude as to each significant federal tax issue, at a more likely than not confidence level, that the taxpayer will prevail on the merits. A marketed opinion is not a covered opinion only if it provides three specific disclaimers: a recommendation to seek independent tax advice; a statement that the advice cannot be relied upon to avoid penalties; and a statement that the advice was written to support promotion or marketing of the transaction.¹⁵

Patent holders who grant licenses under licensing agreements may need to evaluate the facts and circumstances of the licensing arrangement to decide whether the agreement falls within the Circular 230 covered opinion rules or the other written advice rules. If a licensing

¹⁵ This exception does not apply if the marketed opinion is provided in respect of a listed (or similar) transaction or a transaction with a principal purpose of tax avoidance.

agreement provides a statement regarding the efficacy of the tax strategy on which the licensee might rely for penalty protection or incorporates such a statement from the patent, Circular 230 might be implicated. Moreover, if the tax strategy described in the patent were similar to an existing listed transaction or if it had a principal purpose of tax avoidance, the covered opinion rules could apply. In addition, even if a patented tax strategy were not listed and did not have a principal purpose of tax avoidance, it might have a significant purpose of tax avoidance and be construed as rendered at a more likely than not confidence level. In that case, it would qualify as a reliance opinion. Furthermore, given the nature of the subject matter and the context of the communication, tax statements made in a tax patent license or related documents may be used to promote, market or recommend the underlying tax strategy to taxpayers. If that is the case, such licensing agreements would, therefore, be considered marketed opinions.

Two exceptions from covered opinion status may be available. First, some licensing agreements may be eligible for disclaimers that would permit the opinions to be governed by the “other written opinion” rules rather than the covered opinion rules. Although any tax opinion in connection with a listed transaction or a transaction with a principal purpose of tax avoidance cannot avoid the covered opinion rules by disclaimer, an opinion that would otherwise qualify as a marketed or reliance opinion can avoid the more onerous covered opinion requirements by providing the appropriate disclaimers, including a statement that the recipient of the opinion may not rely on the opinion for penalty protection.

Second, the tax consequences of the patented tax strategy may be incidental to the primary purpose of the patent. For example, the tax planning method that qualifies the patented strategy as a “patented transaction” for the reportable transaction rules may also qualify the strategy as a transaction with a significant purpose of tax avoidance under the covered opinion

rules of Section 10.35. The tax planning method, however, may not be offered with a more likely than not level of assurance because it is described as an incidental and potential consequence of the transaction, with some confidence level below more likely than not. Such transactions may fall within the “other written opinions” category of Section 10.37.

(ii) Patent promotional materials. Tax strategy patent promotional materials may include written information about the patent, its purpose and its intended consequences and tax benefits. Those promotional materials may constitute written advice within the meaning of Circular 230. Such written materials promoting patents may come within Circular 230’s written opinion requirements for marketed opinions if a Circular 230 practitioner has prepared the advice and knows or has reason to know that the advice will be used to promote the use of the patent.

(iii) Patent applications and patents. Prior to its use as the basis for a licensing agreement or its inclusion in promotional materials, a tax strategy patent should not be considered a tax opinion subject to the requirements of Circular 230. The patent itself (and the patent application) might be viewed as analogous to an academic article about the tax consequences of a particular strategy.¹⁶ As a communication directed solely to a government agency, it does not yet constitute written tax advice, even though it may be prepared with that objective in mind.

(iv) Tax strategy is patented by practitioner’s client. It is possible that a client, rather than the tax practitioner who advised the client, may apply for a patent on a tax strategy developed by the practitioner. The client may use another practitioner, who may or may not be a tax expert, in prosecuting and licensing the patent. Under Circular 230, attorneys or CPAs who do not affirmatively seek admission to practice before the IRS or who are not tax experts

¹⁶ It is our understanding that academic articles are not intended to be subject to Circular 230.

nonetheless could be treated as Circular 230 practitioners when they issue tax statements to third parties that constitute tax advice, and thus may be subject to the various sanctions under Circular 230 for failure to comply with the Circular 230 written opinion and solicitation requirements. The practitioner who originally developed the strategy, however, would not be treated as providing a covered opinion in connection with the patented transaction unless that practitioner has issued a marketed opinion, which seems unlikely under these circumstances.¹⁷ Although that practitioner may have provided a written opinion to the client that forms the basis on which the client sought the patent for the tax strategy, the practitioner was serving the client in a specific capacity and did not participate in, or receive any benefit from, the application for the tax strategy patent.

b. Other Circular 230 requirements that may apply to patented transactions. To the extent that, as described above, tax strategy patent license agreements may be subject to the Circular 230 written tax advice rules, a number of additional Circular 230 provisions may apply. These include Sections 10.27 (regulating fees charged for any matter before the IRS), 10.29 (dealing with conflicts of interest) and 10.30 (restricting advertising and solicitation).

(i) Section 10.27. Section 10.27 prohibits a practitioner from charging an “unconscionable fee” and regulates the manner in which a practitioner may charge a contingent fee, in both cases, “in connection with any matter before the Internal Revenue Service.” As discussed above, the written tax advice rules of Sections 10.35 and 10.37 may apply when a practitioner provides written tax advice that is used in a patent license or in promoting a patent because, among other factors, the practitioner is considered to be practicing before the IRS.

¹⁷ See Section 10.35(b)(5)(i). Of course, the practitioner’s written opinion to the client may be subject to either the covered opinion or written advice rules, depending on the nature of the opinion, without regard to whether the tax strategy is patented.

Consequently, the fee regulation provisions of Section 10.27 may apply as well under such circumstances. This possibility raises a number of issues.

It is not clear under Section 10.27 whether a practitioner who holds a patent on a tax planning method may charge a client both a permissible legal fee and a license fee in connection with implementing the practitioner's patented tax strategy. Nor is it clear whether Section 10.27 applies either to limit the amount of the license fee or to preclude the charging of a license fee that is contingent on the success of the tax strategy.

Further, the prohibition set forth in Section 10.27(a) on unconscionable fees may apply to tax patent license fees, although it is uncertain how it should apply. In some cases, a practitioner who is a patent holder may provide tax planning advice and access to use of the practitioner's patented tax strategy, charging the client both a legal fee and a license fee. In other cases, the patent holder may only charge the client a license fee for use of the patented tax strategy, and another practitioner may charge the client a legal fee to assist the client in implementing the patented tax strategy. The patent holder would have an incentive to charge a significantly higher fee when another practitioner offers legal advice than the patent holder would charge when the patent holder's own client licenses the strategy, thus using the patent to gain a competitive advantage in attracting clients. Obtaining a competitive advantage may be viewed as an intended benefit of patent rights, but it may also have the effect of effectively depriving the client of his choice of counsel. Thus, it is possible that such a differential fee arrangement could be characterized as "unconscionable" under Section 10.27(a). We suggest that the Treasury Department and IRS seek further input on this issue.

(ii) Section 10.29. A practitioner holding a patent on a tax strategy who would like to recommend the strategy to a client faces a number of possible conflicts of interest

because the licensing of the strategy would initiate a business transaction between the practitioner and client.¹⁸ For example, because the proposal originated with the client's lawyer, the client may not have independent counsel to advise on the fairness of the transaction. It is also possible that the practitioner may be reluctant to suggest alternative planning strategies that are not patented, in favor of the practitioner's patented strategy. We believe the current rule is adequate to address this situation. It will be important, however, to monitor developments to determine whether any modifications in the rule are necessary to ensure that such conflicts do not undermine the attorney-client relationship.

(iii) Section 10.30. Section 10.30(1) prohibits a practitioner, with respect to "any Internal Revenue Service matter," from using or participating in the use of "any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim." If a tax strategy patent license includes such a false or misleading statement, a practitioner who is subject to Circular 230 and who participates in the promotion of patented tax strategies may violate Section 10.30.

c. Recommendations.

(i) Notice regarding potential Circular 230 applicability. We recommend that the Treasury Department and IRS notify taxpayers regarding the possible application of Circular 230 to licensing agreements in respect of patented transactions. This could be done by describing the issues in the preamble to the final patented transaction regulations or by issuing a separate notice. We also recommend that this notice invite comments on the issues.

(ii) Changes to Circular 230. It would be helpful to amend certain sections of Circular 230 to clarify their applicability to patented transactions.

¹⁸ See American Bar Association Model Rules of Professional Conduct, Rule 1.8(a). This Rule provides rigorous standards that must be satisfied by a lawyer engaging in a business transaction with a client.

(A) Definition of practice before the Internal Revenue Service. To assist in making practitioners aware of the potential applicability of Circular 230 to tax strategy patent licensing agreements, we recommend that the definition of “practice before the Internal Revenue Service” in Section 10.2(a)(4) be amended to include “licensing or other agreements for patented transactions, when those licensing or other agreements provide a statement (or incorporate by reference such a statement included in the patent) as described in 26 C.F.R. § 301.6111-3(b)(2)(ii)(E).”

(B) Solicitations. We recommend addition of a reference to patented tax strategy transactions in Section 10.30 regarding solicitations containing false or fraudulent statements. The potential violation of Section 10.30 through promotions of tax strategy patents that rest on invalid interpretations of the tax laws could be clarified by adding the phrase “including by means of promoting the use of a patented transaction (within the meaning of 26 C.F.R. § 1.6011-4(b)(7)) or by means of a licensing or other agreement for a patented transaction” after “solicitation” in the language from Section 10.30(1) quoted above.

(C) Covered opinion requirements. To address the concerns that patent holders and practitioners who advise their clients in respect of patented tax strategy transactions may not be aware of the potential applicability of the covered opinion rules to patented tax strategy transactions, we recommend amending Section 10.35(b) to add a new subdivision that refers to Section 10.2(a)(4), as proposed to be amended above.

In addition, as noted in Part 2 of these Comments, the Treasury Department and the IRS have expressed concern that the issuance of a tax strategy patent might be misinterpreted as an acknowledgement by the IRS and the Treasury Department that the tax benefits claimed in the patent will be achieved. Both practitioners and taxpayers may be misled by this apparent

“governmental approval” of the patented tax strategy and therefore may fail to subject the patented tax strategy transaction to appropriate analysis in order to evaluate properly whether it provides the tax benefits claimed. Accordingly, we recommend that Section 10.37 be amended to require that written advice provided by a practitioner concerning Federal tax issues included in or referred to by a patent licensing agreement must prominently disclose that the issuance of a patent with respect to a tax planning method by the U.S. Patent and Trademark Office does not mean or imply that the IRS or the Treasury Department approve of any tax statements made in the patent.

(D) Fees. We recommend that the Treasury Department and the IRS seek input on: (i) whether a practitioner who holds a tax strategy patent should be permitted to charge both a license fee and a legal fee to a client for implementing the strategy; (ii) whether and, if so, how the prohibition on charging an unconscionable fee should apply to license fees for the use of a tax strategy patent; and (iii) whether Section 10.27 should be amended to prohibit a practitioner from charging a license fee for the use of a patented tax strategy that is a contingent fee within the meaning of Section 10.27(c)(1).