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January 29, 2008

Ms. Linda Stiff
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

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

Dear Acting Commissioner Stiff:

Enclosed are comments on proposed regulations under sections 6011 and 6111 of the Internal Revenue Code. 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.

The Section of Taxation respectfully requests the opportunity to testify at the public hearing on these proposed regulations scheduled to be held on February 21, 2008. An outline of the topics expected to be addressed in that testimony also is enclosed with this letter.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosures

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
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**COMMENTS CONCERNING PROPOSED REGULATIONS UNDER SECTIONS 6011
AND 6111 OF THE INTERNAL REVENUE CODE
RELATING TO PATENTED TRANSACTIONS**

The following comments (“Comments”) concerning proposed regulations relating to patented 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 and Stuart Lewis. 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 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.

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Date: January 29, 2008

EXECUTIVE SUMMARY

These 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. The Section commends the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) for their efforts to address the tax policy and administration issues arising in connection with the patenting of tax advice or tax strategies, and for making these much-needed proposals. As long as patents may be granted for inventions that include claims with respect to tax matters, it is essential that Treasury and the IRS receive timely information regarding such claims and their utilization.

These Comments provide background information relating to the Proposed Regulations, and make the following observations and recommendations:

- Tax patent information is necessary in order that the IRS and Treasury Department may assess the actual or potential impact on tax administration and tax policy, and respond accordingly.
- In light of the timeline for the patent application process, timely receipt and review of information relating to tax patent applications is essential.
- The effective dates set forth in the Proposed Regulations may need to be adjusted when the rules are finalized.
- The IRS should maintain an ongoing review of published tax patents and tax patent applications.
- The Treasury and IRS should consider additional efforts that may be appropriate to inform taxpayers and practitioners regarding patented tax strategies, and to address the concern noted in the preamble to the Proposed Regulations that a patent for tax advice or a tax strategy might be incorrectly interpreted as approval by the Treasury and IRS of the transaction.

¹ Unless otherwise expressly stated herein, all references to sections are to sections 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.

COMMENTS CONCERNING PROPOSED REGULATIONS UNDER SECTIONS 6011 AND 6111 OF THE INTERNAL REVENUE CODE TO ADD PATENTED TRANSACTIONS AS A CATEGORY OF REPORTABLE TRANSACTIONS

1. Background

The implications for the tax system of patents being granted with respect to tax advice and tax strategies have raised important questions for several years. On July 13, 2006, the House Committee on Ways and Means Subcommittee on Select Revenue Measures held a hearing on the patenting of tax advice.³ That hearing focused attention on this subject and heightened public awareness of the issues, as evidenced by the ensuing publication of articles and by comments attributed to public officials.⁴

The Congressional response to these issues quickly followed. Several legislative proposals have been introduced to prohibit tax strategy patents or to limit their enforcement.⁵ On September 7, 2007, the House of Representatives passed a patent reform bill that includes a prohibition on tax patents,⁶ and on November 15, 2007, the leaders of the Senate Finance Committee introduced legislation that would also prohibit tax patents.⁷ These legislative proposals are pending before Congress.

As discussed further below, the Treasury and IRS require access to timely information regarding tax patents so that they can adequately address the tax policy and administration issues that may arise in connection therewith. This possibility was raised by the staff of the Joint Committee on Taxation in its publication accompanying the July 13, 2006 hearing.⁸ A few months later, in connection with the publication of proposed regulations on reportable transactions, the IRS requested comments on creating a new category of reportable transaction for transactions that use patented tax advice or tax strategies.⁹ In response to this request, the Section supported the establishment of a reportable transaction category with respect to matters

³ Hearing on Issues Relating to the Patenting of Tax Advice: Hearing before the Subcomm. on Select Revenue Measures and the H. Comm. on Ways and Means, 109th Cong. (2006); *see also* Joint Comm. on Taxation, Background and Issues Relating to the Patenting of Tax Advice, JCX-31-06 (July 12, 2006) (hereafter “Joint Committee Pamphlet”).

⁴ *See* ABA Section of Taxation Task Force on Patenting of Tax Strategies, Bibliography, “Material on Tax Strategy Patents (through November 1, 2007),” available at <http://www.abanet.org/tax/patents>.

⁵ Sec. 303 of S. 681, 110th Cong. 1st Sess. (Feb. 17, 2007) (Senator Levin and others) (prohibition on “tax shelter” patents); Sec. 303 of H.R. 2136, 110th Cong. 1st Sess. (May 3, 2007) (Rep. Doggett and others) (same); H.R. 2365, 110th Cong. 1st Sess. (May 17, 2007) (Rep. Boucher and others) (limitation on damages and other remedies with respect to patents for tax planning methods).

⁶ Sec. 10 of H.R. 1908, Patent Reform Act of 2007 (passed the House of Representatives on Sept. 7, 2007) (tax planning methods not patentable); *see* H.R. Rept. No. 110-314, 110th Cong. 1st Sess. 38-39, 54-55, 79-80, 91, and Letter from Representatives Jim McCrery and Charles Rangel to Colleagues (Sept. 6, 2007).

⁷ S. 2369, 110th Cong. 1st Sess. (Nov. 15, 2007) (Senators Baucus, Grassley and others) (prohibition on tax patents).

⁸ Joint Committee Pamphlet at 23.

⁹ Proposed Regulations on Reportable Transactions, 71 Fed. Reg. 64488, 64490 (Nov. 2, 2006).

relating to tax patents and made additional recommendations.¹⁰ The other commentators, with one exception, supported the creation of a new reportable transaction category for tax patents.¹¹

We commend Treasury and the IRS for publishing the Proposed Regulations. We note the creativity and thoroughness evident in the proposal, particularly given the absence of any clear frame of reference from which to approach the issue. These Comments explain why, in general, the information sought to be obtained by implementing the Proposed Regulations is vital to the missions of both Treasury and the IRS. We also discuss at what point in the patent application process disclosure should be required; the effective dates for the Proposed Regulations; and the need to continually monitor published tax patent applications and tax patents.

2. Need for tax patent reporting rules

As explained in our 2007 Comments, adding a new category of reportable transaction for patented transactions to Regulation section 1.6011-4 will assist the IRS and Treasury Department in their fundamental duties of ensuring effective tax administration and overseeing tax policy. Such reporting will help protect the integrity of our country's tax laws and its system of voluntary compliance by providing timely information regarding tax patent applications and grants, as well as their utilization.¹²

All U.S. taxpayers are subject to our tax laws and to our system of voluntary self-assessment. Compliance is obligatory. Equal treatment by the government of all taxpayers under the tax laws is fundamental to the integrity of the tax system. It is also important that the public perceive the tax system as operating fairly. A grant of a patent, however, gives a private party the legal right for 20 years to prevent others from making, selling, using or importing a patented invention – in effect, conferring a monopoly to the holder of a patent. As a result, in the case of many patented tax strategies, such grants will have the effect of privatizing provisions and interpretations of the tax law. The holder of a tax strategy patent has a legal right to restrict another's access to complying with the law. In the case of a tax strategy patent, the patent holder, rather than Congress, would decide eligibility for obtaining a tax advantage. Under current law, patent holders can refuse to license a tax strategy technique to anyone, including their competitors. Private control through patents would allow holders of patents to charge monopoly prices for taxpayers to use methods to enable them to best comply with our country's tax laws. Such rights could, therefore, require tax advisors to incur substantial additional costs and taxpayers to assume additional risks in structuring their transactions. Reaction to the consequence of tax strategy patents is likely to complicate our tax laws further. Moreover, patent examiners cannot consider policy other than patent policy in granting patents. Accordingly, there is potential for divergence between the consequences of tax patents and their

¹⁰ ABA Section of Taxation, Comments Concerning a New Category of Reportable Transaction Covering Patent Tax Strategies, available at <http://www.abanet.org/tax/pubpolicy/2007/icindex.html> (“2007 Comments”).

¹¹ The comments are summarized in the Proposed Regulations. 72 Fed. Reg. 54615, 54615-54616 (Sept. 26, 2007).

¹² These Comments assume existing patent law. The enactment of remedial patent legislation could affect the need for the reporting system to be established by Proposed Regulations. See notes 5-7, above.

utilization, on the one hand, and the goals of tax policy and tax administration, on the other hand. Importantly, this potential includes the grant of patents that could facilitate tax avoidance. In view of the foregoing concerns, it is essential that the IRS and the Treasury Department have the earliest possible access to information pertaining to potential and actual tax patent claims, and to information regarding their usage.

In our view, the principal benefit of tax patent reporting is that it will permit the IRS and the Treasury Department to identify the areas of the tax law for which patents are being claimed -- and thus the areas of the tax law that private parties are asserting the right to control. Only if the IRS and Treasury Department have this information available can they consider the impact of such claims, both individually and in the aggregate, and formulate whatever responses may appear to be necessary and appropriate to ensure the proper functioning of our tax laws. The success of this essential task, moreover, depends on the IRS and Treasury Department obtaining this information at the earliest possible stage, ideally at the time the patent application is filed but certainly no later than the date that an application is made public.

In addition, as the preamble to the Proposed Regulations explains, the proposed tax patent reporting requirements will assist the IRS in identifying transactions that have the potential for tax avoidance, but are not otherwise subject to Reg. § 1.6011-4, or that will not be identified under existing reporting regulations until long after the patent is applied for. While we believe that privatization of the tax law is the most fundamental issue raised by tax strategy patents, we recognize that a reporting requirement for tax strategy patents is also needed to ensure the continued viability of the requirement in the existing regulations that participation in a confidential transaction triggers a reporting obligation. *See* Reg. §§ 1.6011-4(b)(3) and 1.6011-4(c)(3)(i)(B). One motivation for seeking patents on tax strategies may be to obtain the economic advantages of confidentiality without the need to impose a requirement of confidentiality and thus trigger IRS scrutiny of the transaction. Although under the patent law the patent itself must be disclosed, the use of the patent may remain confidential.

In explaining the need for the new reporting requirements, the preamble to the Proposed Regulations refers to the possibility of patents encouraging tax avoidance transactions and the possibility that taxpayers might perceive the grant of a patent as implying IRS and Treasury Department approval of the claimed invention, and noted that this “might impede the efforts of the IRS and Treasury Department to obtain information regarding tax avoidance transaction and have an impact on effective tax administration.”¹³

Finally, we recognize that the Proposed Regulations, as with other reporting requirements, may have some deterrent effect on the underlying transactions. Such an outcome is an incidental, but acceptable consequence of an effective reporting system. We respectfully suggest that such consequence not be viewed as an objective of the Proposed Regulations and, therefore, urge that Treasury and the IRS reduce to the extent possible the burdens that could be imposed by the Proposed Regulations.

¹³ 72 Fed. Reg. 54615.

3. Reporting information with respect to the application for a patent

As recommended in our 2007 Comments and for the reasons described in Part 2 of these Comments, we agree with the objective of the Proposed Regulations that the IRS should receive disclosure regarding potential tax patents at the earliest meaningful point. The 2007 Comments noted the substantial time lag between the submission of a patent application and the first time the subject matter is made public under the patent law, much less utilized and reported to the IRS under either the existing reportable transaction disclosure rules or under proposed disclosure that is dependent solely on when patents are granted. Given the potential significance of the information, there is no apparent reason why the IRS and Treasury Department should be placed at such a disadvantage.

By focusing on the tax benefits derived from costs incurred to obtain a patent,¹⁴ the Proposed Regulations make use of the existing structure of Regulations section 1.6011-4 in order to elicit potentially useful information. The Proposed Regulations would require most patent applicants to make disclosures when they file federal income tax returns for the year in which the application costs are incurred. This early disclosure of information should provide timely notice to the IRS and Treasury Department.

Because information would be disclosed prior to the grant of a patent, there is the possibility that some of the information may ultimately be of little or no use. Tax patent claims may not be granted; may be modified; may be withdrawn; and so on. Nonetheless, a decision must be made between waiting many years for patents to be granted and even longer for the disclosure of use of patented claims before first obtaining any information regarding tax claims, on the one hand, and obtaining early notice, perhaps years in advance, of information regarding tax claims that may be granted, at the cost of receiving information that will eventually not be useful, on the other. In the light of the policy concerns noted in Part 2 of these Comments, particularly the need to provide the IRS and Treasury Department with as much time as possible to analyze and react, we continue to believe that advance notice, albeit combined with some information that may eventually prove to be irrelevant, is clearly preferable to the consequences of extensive delay in obtaining any information at all.

Finally, we note that under current patent law, there is no requirement that all patent applications be made public 18 months after the applications are filed. If, however, the patent law were revised to require that all applications be made public at that time, we recommend that the IRS reevaluate the need to obtain information relating to patent applications and their utilization prior to the publication of the application.

4. Effective date issues

The Proposed Regulations specify two sets of effective dates. The first, in Proposed Regulation section 1.6011-4(h)(2), states that the requirement of a statement disclosing

¹⁴ Prop. Reg. §§ 1.6011-4(b)(7)(i)(B) (“patent” includes patents that have been applied for); -4(c)(3)(i)(F) (participation in a patented transaction includes a tax return that reflects a tax benefit in relation to obtaining a patent for a tax planning method); -4(c)(3)(ii), Example 4.

participation in certain patented transactions¹⁵ will, upon publication of the Treasury decision adopting the rules as final regulations, apply to “transactions entered into on or after September 26, 2007.” The second effective date rule similarly states that the two remaining portions of the Proposed Regulations¹⁶ will, upon publication, apply to transactions with respect to which a material advisor makes a tax statement on or after September 26, 2007.¹⁷ Both of these effective dates in effect impose retroactive reporting requirements once these rules are finalized. The retroactive aspect of these effective dates raises certain issues that should be addressed.

With respect to the first above-mentioned effective date (“transactions entered into on or after September 26, 2007”), the wording of the effective date creates uncertainty in certain situations because it is not clear what it means to “enter into” a “transaction” for purposes of the Proposed Regulations. The term “transaction” is defined in Regulation section 1.6011-4(b)(1) as including “all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement and includes any series of steps carried out as part of a plan.”¹⁸ This definition could mean that ongoing transactions continue to be transactions and that, therefore, matters that were initially entered into before September 26, 2007 may nevertheless be covered by the Proposed Regulations, when finalized, if some of the series of “steps” are carried out subsequent to September 25, 2007. For example, if a patent is granted before September 26, 2007, but some of the fees for use of the patent are paid after September 25, 2007, under the language of the effective date rule, that payment may involve a “transaction” subject to these regulations. If the situation involves obtaining a tax patent, the meaning of the concept of when a transaction is entered into is even less certain, given that obtaining a tax patent is a multi-year process.

In order to avoid uncertainty about the application of these rules to transactions that were initiated before September 26, 2007, we suggest that the effective date rules be further clarified. A demarcation that would seem to be consistent not only with the intent of the Proposed Regulations, but also with the concept of imposing a new reporting requirement that heretofore did not exist would involve applying the Proposed Regulations only to situations in which a taxpayer has initially participated in a transaction after September 25, 2007. For this purpose the standard set forth in Proposed Regulation section 1.6011-4(c)(3)(i)(F) (the definition of “patented transaction”) could be used so that a taxpayer would be considered to have entered into a transaction at the point the taxpayer initially participates in a patented transaction by making a payment that produces a tax benefit within the meaning of that regulation.

A second problem created by the effective date rules concerns the practical problem of filing returns for years ending after September 25, 2007, but before the finalization of the regulations. Under the wording of both of the effective date rules these regulations will become effective only upon their finalization. However, during the interim period before finalization (if

¹⁵ Prop. Reg. §§ 1.6011-4(b)(7), -4(c)(3)(i)(F) and -4(c)(3)(ii), Examples 4 through 7.

¹⁶ Prop. Reg. §§ 301.6111-3(b)(2)(ii)(E) and -3(b)(3)(i)(C).

¹⁷ Reg. § 301.6111-3(i)(2).

¹⁸ See also Instructions for Form 8886, Reportable Transaction Disclosure Statement (Rev. December 2005) 1.

there is a significant delay in the finalization of the regulations), taxpayers will be filing tax returns and will not be required to report the transactions described in the Proposed Regulations. The IRS will, therefore, need to consider what type of filing is appropriate in that situation. One possibility is that any reporting of a transaction, either by a taxpayer or a material advisor, that occurs after September 25, 2007, would be made on the first tax return filed after the finalization of the regulations. Thus, if it takes several years to finalize the regulations, then taxpayers (and material advisors) would cumulatively report on patented transactions as part of the tax return filed for the year in which the regulations are finalized. Another possibility that should be considered, especially if there is a substantial delay in finalization the regulations, is to adjust the effective date of the regulations to a date more closely related to the finalization of the regulations. This latter approach may be particularly appropriate if external considerations, such as the pendency of legislation,¹⁹ cause extensive delays in the finalization of these regulations.

5. Review of published tax patent applications and tax patent grants

Regardless of whether the reporting regime in the Proposed Regulations is ultimately adopted or whether remedial patent legislation is enacted, for the reasons described in Part 2 of these Comments, the IRS and Treasury Department need to be informed regarding patents that could affect the functioning of the tax system.²⁰ Accordingly, to the extent not already occurring, we urge that the IRS systematically review and analyze on an ongoing basis all published patent applications and all patent grants that could have an impact on tax administration or tax policy.

6. Additional efforts to inform taxpayers regarding tax patents

As discussed above, the preamble to the Proposed Regulations expressed the concern that a patent for tax advice or a tax strategy might be interpreted by taxpayers as approval of a transaction by the Treasury or the IRS. Although such an interpretation clearly would not be accurate, in the interests of promoting effective tax administration, the IRS may want to consider whether to pursue taxpayer outreach efforts, including public service announcements or other releases, through which it could educate taxpayers and practitioners regarding these issues.

In addition, the Treasury and IRS may want to consider amending Regulation section 1.6662-4(d)(3)(iii) or otherwise issuing guidance that makes clear that the grant of a patent does not constitute “authority” for purposes of determining the appropriateness of imposing penalties on taxpayers or return preparers under sections 6662 and 6694 of the Code.

¹⁹ See notes 5-7, above.

²⁰ We note in this regard the recent legislative proposal by the National Taxpayer Advocate to require the U.S. Patent and Trademark Office (“PTO”) to transmit tax strategy patent applications to the IRS in order that the IRS can (1) address any abuse presented by the application and (2) help PTO identify “obvious” tax strategy patent claims that should not be granted. See 1 National Taxpayer Advocate 2007 Report to Congress (Jan. 9, 2008) 463, 512-524.

American Bar Association Section of Taxation

Outline of topics to be discussed at February 21, 2008 public hearing on notice of proposed rulemaking relating to the addition of a patented transaction category of reportable transactions under sections 6011 and 6111 of the Internal Revenue Code (REG-129916-07)

Topics to be discussed

1. Background regarding the patenting of inventions relating to tax advice and tax strategies. [2 minutes]
2. The need for the proposed addition to the Regulations relating to disclosures of reportable transactions: the information is necessary to assist the IRS and the Department of the Treasury to assess the actual or potential impact of these patents on tax administration and tax policy, and to formulate appropriate responses. [2 minutes]
3. Explanation of why disclosure is appropriate at the earliest opportunity in the patent application process. [2 minutes]
4. Recommended adjustments to the effective dates of the proposed regulations. [1 minute]
5. The need for ongoing IRS and Treasury Department review and analysis of published tax patent applications and tax patents. [2 minutes]
6. The need for additional public outreach by the IRS and Treasury Department regarding reliance on tax patents as support for positions taken on tax returns. [1 minute]