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February 21, 2007

The Honorable Mark W. Everson  
Commissioner of Internal Revenue  
Internal Revenue Service  
Room 5226  
1111 Constitution Avenue NW  
Washington, DC 20224

Re: Comments Concerning a New Category of Reportable Transaction Covering  
Patented Tax Strategies

Dear Commissioner Everson:

Enclosed are comments concerning a new category of reportable transaction covering patented tax strategies. 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,

Susan P. Serota  
Chair, Section of Taxation

Enclosure

Cc: Donald L. Korb, Chief Counsel, Internal Revenue Service  
Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury  
Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury  
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## **COMMENTS CONCERNING A NEW CATEGORY OF REPORTABLE TRANSACTION COVERING PATENTED TAX STRATEGIES**

These comments (the “Comments”) concern the creation of a new category of reportable transaction for transactions that use patented tax strategies. The Comments also address certain related matters. The Comments are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Comments were prepared by members of the Section’s Task Force on Patenting of Tax Strategies (the “Task Force”). Principal responsibility was exercised by Dennis B. Drapkin. Substantive contributions were made by Ellen Aprill, Derek Bambauer, Michael Lang, Stuart Lewis and Charles Pulaski. The Comments were reviewed by William Wilkins of the Section’s Committee on Government Submissions and Susan Serota, Council Director for the Task Force.

Although the members of the Section who participated in preparing these Comments have clients who could be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, 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: February 21, 2007

## EXECUTIVE SUMMARY

These Comments have been prepared in response to the request for comments on creating a new category of reportable transaction for transactions that use patented tax advice or tax strategies. The request is set forth in the preamble to the proposed regulations on disclosure of reportable transactions by taxpayers under section 6011 of the Internal Revenue Code of 1986, as amended (the “IRC”),<sup>1</sup> published in the Federal Register on November 2, 2006. 71 Fed. Reg. 64488, 64490. The Section commends the Internal Revenue Service (the “IRS”) for soliciting input on this critical subject.

These Comments make recommendations regarding the following:

- Creation of a new category of reportable transaction for transactions that use patented tax strategies.
- Expansion of the material advisor rules to include persons who license tax patents to others or who provide tax statements regarding tax patents.
- Consideration of whether the IRS should receive patent applications pertaining to tax strategies at the time the applications are filed with the United States Patent and Trademark Office (the “PTO”).

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<sup>1</sup> Unless otherwise indicated, all section references are to the IRC or to proposed, temporary or final regulations promulgated thereunder, as applicable.

## COMMENTS CONCERNING A NEW CATEGORY OF REPORTABLE TRANSACTION COVERING PATENTED TAX STRATEGIES

### 1. Background.

The 1998 *State Street Bank* case<sup>2</sup> held that business methods may constitute patentable subject matter. In PTO's view, patentable business methods may include tax strategies. In its subcategory for tax strategy patents, the PTO website shows more than 50 issued patents and more than 80 published applications.<sup>3</sup>

A patent confers a 20-year monopoly from the federal government over the invention claimed in the patent, effective from the date the application is filed. It gives the patentee the right to exclude others from making, using, selling or importing the patented invention. A patentee may, but is not required to, license others to use the patented invention. Patentees may bring an action for monetary damages for patent infringement and to enjoin the defendant's infringing actions. 35 U.S.C. §§ 112, 154(a)(2), 261, 271, 281, 283 and 284.

Granting patents for methods or processes that use tax strategies raise important issues of tax policy and tax administration, including the following:

- A. Should the federal government grant monopoly control to private parties over the terms under which portions of the tax law may be used, or should the tax law be available on the same terms to all taxpayers?
- B. Should Congress' ability to influence taxpayer behavior through the tax law be subject to patents granted to private parties?
- C. Do the goals and objectives of the patent system justify imposing on taxpayers and their advisors the additional costs, uncertainties and risks attributable to the possible application of patents in addition to the already significant costs and complexity of compliance with the tax system?
- D. Should patents be granted that have the effect of facilitating tax avoidance, thereby reducing federal revenues?
- E. Should patents be granted with respect to claims that constitute abusive or aggressive interpretations of the tax law that are unlikely to be sustained?

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<sup>2</sup> *State Street Bank & Trust v. Signature Fin. Group, Inc.*, 149 F. 3d 1368 (Fed Cir. 1998), cert. denied, 525 U.S. 1093 (1999).

<sup>3</sup> <http://www.uspto.gov/patft/index.html>, results of the following search: ccl/705/36T. Although these numbers are relatively small, they are almost certainly understated. Some tax patents have been classified by PTO in a manner that makes identification difficult. In addition, as discussed below, patent applications are generally not published for 18 months after filing and, if the applicant certifies that foreign patent protection will not be sought, the application is not published at all. Finally, greater public discussion of tax patents may stimulate growth of tax patent applications.

- F. Do tax patents provide a means to avoid the reportable transaction requirements for confidential transactions?
- G. If taxpayers and others consider the grant of a patent as constituting government approval of the underlying tax strategy or tax advice, what remedial steps should be taken?

In order to address these issues, the IRS and the Treasury Department (the “Treasury”) need to obtain timely information about applications for and use of patented tax strategies, including those patents that pertain to tax shelters and other aggressive transactions. This critical need forms the basis for the Section’s recommendations.

## **2. New reportable transaction category.**

A new category of reportable transaction (a “tax patent transaction”) should be established to inform the IRS about the use of patented tax strategies. Taxpayers should be required to report their participation in any transaction that uses such strategy for each taxable year for which the taxpayer’s return reports an item attributable to such a transaction. For this purpose, “transaction” would have the meaning set forth in Prop. Reg. § 1.6011-4(b)(1) and “participation” would be defined consistently with Prop. Reg. § 1.6011-4(c)(3). It should be made clear, however, that the use of patented methods or processes for complying with return preparation and filing or other administrative requirements does not for this purpose constitute a “transaction.” For example, if a taxpayer licenses and uses a patented method for gathering data necessary to comply with a requirement of the Internal Revenue Code, such activity would not constitute a “transaction.” On the other hand, if a taxpayer owns, or obtains a license to use, a patented process or method that, if followed, purports to provide a reduction in tax or other substantive tax result, the implementation of such method constitutes a “transaction.”

In some situations it may be difficult to determine whether a tax patent claim or series of claims is limited only to methods or processes for demonstrating compliance with tax law requirements, such as methods of data gathering and processing, or whether the claim or series of claims covers an interpretation of, or inferences drawn from, the tax law. For example, commentators differ as to whether the patent at issue in *State Street Bank* was limited only to the processing of data necessary for tax compliance (and for other non-tax reasons) or whether the claims included one, and perhaps the only, method of complying with applicable partnership tax rules.<sup>4</sup> In such a case, since the purpose of the reportable transaction regulations is to bring potentially significant information to the attention of the IRS in a timely manner, any doubts regarding the coverage of the regulation should be resolved in favor of reporting. If the IRS subsequently concludes that

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<sup>4</sup> Lederman, Tax-Related Patents: A Novel Incentive or an Obvious Mistake?, 105 J. of Tax. 325, 332-333, 334 (Dec. 2006) (text at notes 56-61 and 73-74); compare Joint Comm. on Taxation, Background and Issues Relating to the Patenting of Tax Advice, JCX-31-06 (July 12, 2006) at 18 (hereafter “Joint Committee Pamphlet”).

the subject matter required to be reported is too broad, the scope of the regulation can be narrowed at that time, as the IRS has done in the past.<sup>5</sup>

It seems inappropriate, and in some cases unfair, to impose tax patent reporting obligations on a taxpayer who does not, at the time the return is filed, use the patent laws. Therefore, in order to be a tax patent transaction, the taxpayer must, at the time the return is filed, have a legal right to use the patented tax strategy, such as through ownership of the patent or by means of a license. Thus, if a taxpayer engages in a tax strategy that has been patented, but the taxpayer is unaware of the existence of the patent or decides to proceed without obtaining the legal right to utilize the patent, the taxpayer would not be considered to have participated in a tax patent transaction. This determination would be made at the time the tax return is filed. Accordingly, if after the relevant return is filed, the taxpayer enters into a license to use a patented tax strategy in response, for example, to an assertion of possible infringement, there would be no reporting obligation.

Tax method patents have been granted with respect to taxes other than income taxes, such as the estate and gift taxes.<sup>6</sup> Therefore, for the purpose of this reportable transaction, the term “tax” should include any tax imposed by title 26 of the Internal Revenue Code, rather than being limited to income taxes. See Prop. Reg. § 1.6011-4(c)(5); compare Prop. Reg. § 301.6111-3(c)(6).

As with other types of tax planning, it is possible that the tax consequences of implementing a patented tax strategy may not be reportable on a tax return until long after the transaction has been entered into. See IRC § 6011(a); Prop. Reg. § 1.6011-4(c)(3). Thus, there could be a substantial interval between the utilization of a patented tax strategy and the filing of a statement disclosing participation in the strategy. This is a deficiency, since it is the existence of a patented tax strategy that is of paramount interest to the IRS and the Treasury. Because this deficiency is inherent in the overall reportable transaction structure, no specific recommendation is being made. See Part 4 of the Comments, below, however, for a separate recommendation that would address this problem.

### **3. Material advisor.**

If a new category of reportable transaction is created with respect to patented tax strategies, attention should be given to the integration of the new reportable transaction category with the material advisor reporting requirements in section 6111. For the reasons set forth below, we

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<sup>5</sup> See, e.g., TD 9108 (Dec. 29, 2003) (narrowing reportable confidential transactions); Rev. Proc. 2004-65, 2004-50 IRB 965 (exceptions to contractual protection reportable transactions); Rev. Proc. 2004-66, 2004-50 IRB 966 (exceptions for reportable loss transactions); Rev. Proc. 2004-68, 2004-50 IRB 969 (exceptions to brief asset holding period reportable transactions); Notice 2006-6, 2006-5 IRB 385 (elimination of book-tax difference reportable transactions); Rev. Proc. 2007-20, 2007-7 IRB 1 (exceptions to contractual protection reportable transactions).

<sup>6</sup> See, e.g., U.S. Patent No. 6,567,790 (the so-called “SOG RAT” patent), designed to reduce estate and gift tax liability.

recommend that a tax patent licensor and certain other tax patent advisors be considered as potential material advisors.

The definition of “material advisor” with respect to a tax patent transaction should generally track the proposed guidance. See Prop. Reg. § 301.6111-3. Thus, a material advisor would include a person who licenses to another the right to use a tax patent or who otherwise provides a service described in Prop. Reg. § 301.6111-3(b)(1) with respect to such activity; who makes a tax statement with respect to the tax patent transaction; and who meets the threshold amount requirements. In the case of a tax patent transaction, a tax statement would include a communication of any aspect of the tax consequences to be derived from implementation of the tax-related claims made in the patent underlying a tax patent transaction. This communication could, among other means, take the form of a direct written statement regarding the tax consequences; transmittal of all or a portion of the patent; or any direct or indirect reference to the existence of the patent. This treatment would be analogous to the proposed material advisor status for a third party that provides insurance with respect to the tax consequences of a reportable transaction. See Prop. Reg. §§ 301.6111-3(b)(2)(ii)(A), -3(c)(12).

The threshold amount for material advisor status with respect to a tax patent transaction is problematic. The general threshold amount is \$50,000 if substantially all of the benefits of a reportable transaction are provided to natural persons and \$250,000 otherwise.

IRC § 6111(b)(1)(B). In the recently proposed tax shelter regulations, the IRS relies on the authority granted in IRC section 6111(b)(1)(A)(ii) to reduce the threshold amounts in certain circumstances. Prop. Reg. § 301.6111-3(b)(3)(i)(B). We do not have a factual basis on which to evaluate the efficacy of any particular threshold amount with respect to a tax patent transaction. We suspect, however, that the general amounts set forth in section 6111(b)(1)(B) would have the effect of exempting most potential material advisors with respect to a tax patent transaction, and that lower threshold amounts will need to be established by regulation. In addition, for purposes of determining whether the threshold amount has been exceeded, consideration should be given to aggregating all income derived by a potential material advisor with respect to a patent during a calendar year, without regard to the number of ultimate taxpayers involved.

Clarification would be helpful for the application of the list maintenance requirements to material advisors with respect to tax patent transactions. IRC § 6112; Prop. Reg. § 301.6112-1. For example, if a person becomes a material advisor by reason of licensing the use of a tax strategy patent to others, the list maintenance requirement should encompass all of the licenses granted by such person with respect to the patent. In such case, the licenses would be viewed as “substantially similar transactions” for purposes of Prop. Reg. § 301.6112-1(b)(1), rather than requiring a separate list for each reportable transaction derived from the patent.

#### **4. Reporting tax patent applications to the IRS.**

For the reasons noted in Part 1 of the Comments, we believe that the IRS and the Treasury should be informed promptly of patent applications pertaining to tax strategies. Although utilization of the reportable transaction structure would further this objective, we are concerned about the substantial time lag between the submission of a patent application and the first time

the subject matter is made public, much less utilized and reported to the IRS as recommended in Part 2 of the Comments.<sup>7</sup> Patent applications are generally made public 18 months after submission. 35 U.S.C. § 122(b). If the applicant certifies that the applicant will not seek foreign patent protection, however, the application will not be made public and information regarding the patent will not be revealed unless and until the patent is granted. *Id.* Because there appears to be no benefit to be derived from foreign patent protection for U.S. tax strategies, it is possible that most tax patent applicants will forego foreign patent protection and thereby qualify for the certification, thus assuring secrecy until a patent is granted.<sup>8</sup> The significance of this delay is amplified by the amount of time it takes for PTO to complete its review of an application and render a final decision. For example, the SOGRAT patent was applied for in December 1999 and granted in May 2003.

As a result, absent a change in procedures, the IRS and the Treasury will have no knowledge about the subject matter of tax patents, which may be vital to the proper administration of the tax laws, until the patents are granted years after the applications have been filed. Although specific utilization of tax patents could eventually be revealed pursuant to reportable transactions, we believe that the IRS should receive notice at the time a patent is applied for, rather than await actual utilization. If the application discloses an abusive or aggressive interpretation of the tax law, the IRS can take prompt remedial action. Even if the application describes a legitimate interpretation of the tax law, since the issuance of a patent conveys a monopoly to control a portion of the tax law, the agencies responsible for tax administration and tax policy should have the maximum opportunity to ascertain and evaluate the potential impact on the tax system of the grant of the patent and to consider whether legislative or administrative responses are warranted. The possibility that the grant of a tax patent application could facilitate transactions that result in loss of federal tax revenues would seem to be sufficient reason for the agencies responsible for raising federal revenues to receive immediate notification.

Accordingly, we recommend that whenever a tax patent application is filed, a copy should be sent by the applicant to the IRS under the same conditions of confidentiality that apply to patent applications submitted to PTO. It has been suggested that this may be accomplished by regulation. Joint Committee Pamphlet at 23. While we are uncertain whether such administrative authority exists, we urge that appropriate measures be taken so that IRS can promptly review all tax patent applications.

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<sup>7</sup> This problem would be ameliorated to some extent if the definition of “material advisor” is expanded as recommended in Part 3 of the Comments. As noted above, however, there is uncertainty regarding the appropriate threshold amounts and the level at which those amounts are set may substantially affect the volume of material advisor disclosures. Moreover, it is possible that material advisor status with respect to tax patents may not arise until after the tax patent has been granted.

<sup>8</sup> Wieland and Marshall, Tax Strategy Patents - Policy and Practical Considerations, 47 Tax Mngt. Memo. 499, 500-501 (Dec. 11, 2006).