

Summer 2017 Student Update Memorandum for

Maine & Nguyen's

**Intellectual Property Taxation:
Problems and Materials
(2nd ed. 2015)**

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Chapter 2

Overview of Intellectual Property

Page 13: In 2014, the Supreme Court addressed patentable subject matter again in a software patent case. *See Alice Corp. Pty. Ltd. v. CLS Bank Int'l*, 134 S. Ct. 2347 (2014).

Page 16: In *Samsung v. Apple*, 137 S. Ct. 429 (2016), the Supreme Court addressed design patent infringement.

Page 18: Absolute secrecy is not required for trade secret protection. *See Hallmark Cards v. Monitor Clipper Partners*, 758 F.3d 1051 (8th Cir. 2014).

Page 19: Statutory damages are available in copyright infringement cases. Reasonable royalties as a measure of damages (common in patent infringement cases but rarer in copyright infringement cases) were recently addressed in *Oracle Corp. v. SAT AG*, 765 F.3d 1081 (9th Cir. 2014) (reducing the \$1.2 billion jury verdict in a copyright infringement case due to the speculative nature of the calculation of the damages).

Chapter 3

Overview of Traditional Principles of Federal Income Taxation

Page 60: In 2017, the AMT 28% rate begins at \$187,800. For 2017, the exemption amounts are \$54,300 for unmarried individuals and \$84,500 for joint filers. Rev. Proc. 2016-55. These exemptions are phased out for high income taxpayers.

Chapter 4

Taxation of Intellectual Property Development

Page 79: The regulations under section 263A include licensing costs in the non-exclusive list of indirect costs that must be capitalized to the extent they are properly allocable to property produced. Treas. Reg. 1.263A-1(e)(3)(ii). Those costs include minimum annual payments and royalties that are incurred by a licensee. *See* IRS Field Attorney Advice 20145101F (May 8, 2014) (concluding that royalties paid under a patent license are indirect costs that are properly allocable to production of property and, thus, must be capitalized).

Page 80: The Protecting Americans from Tax Hikes (PATH) Act of 2015 recently extended the section 181 deduction for two years to qualified film and television productions commencing prior to January 1, 2017. It expired December 31, 2016. At the time of this supplement, legislation was proposed extending it again. It is worth emphasizing that an election must be made to allow the deduction of film production costs. *See* *Kantchev v. Commissioner*, T.C. Memo 2015-234 (Dec. 3, 2015).

Page 81: For recent tax cases involving book writing activities, *see* *Rangen v. Commissioner*, T.C. Summ. Op. 2014-62 (denying deductions for expenses for taxpayer's activities as a writer and cartoonist); *Ballard-Bey v. Commissioner*, T.C. Summ Op. 2014-62 (concluding that although the taxpayer undertook his book writing activity with the honest intent to generate a profit, his profit-seeking activity was not functioning as a going concern in the years at issue); *Pingel v. Commissioner*, T.C. Summ Op. 2015-48 (disallowing expenses of a purported travel guide writer who trekked through Europe and Africa to write about his experiences).

Page 82: In July 2014, the IRS issued final regulations under section 174 that adopt, with some modifications, regulations that were proposed a year earlier. The final regulations provide:

- The ultimate success, failure, sale, or other use of the research or property resulting from research is not relevant to eligibility under section 174. Thus, taxpayers no longer need to be concerned about otherwise qualified expenses being disallowed because of an ultimate sale, which is often unforeseen.
- The “depreciable property rule” discussed below is an application of the general definition of research or experimental expenditures and should not be applied to exclude otherwise eligible expenditures.
- The term “pilot model” is defined as any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or implementation of the product. By redefining the definition of pilot model, issues that existed regarding the inclusive and exclusive nature of the term have been greatly resolved.
- The costs of producing a product after uncertainty concerning the development or improvement of a product is eliminated are not eligible under section 174.

- A shrinking-back rule applies when eligibility requirements are met with respect to only a component part of a larger product, but not the overall product itself. T.D. 9680 (eff. July 21, 2014). The shrinking back provision recognizes situations in which component costs can qualify even though basic design specifications of the product are certain.

Page 85: It has been suggested that start-up businesses, which may be entitled to section 174 deductions, are not subject to the at-risk rules of section 465. See Daniel Willingham, *How Start-Ups and Their Investors Can Avoid the At-Risk Rules*, Tax Notes Today, Oct. 26, 2015, available at 2016 TNT 46-8. Do you agree?

Page 88: Until recently, the research credit was continually renewed as a temporary provision. On December 18, 2015, President Obama signed into law a tax extenders bill making the research credit permanent for tax years starting in 2015. The Protecting Americans from Tax Hikes (PATH) Act (P.L. 114-113). The legislation also expanded the credit so that some start-up companies and small businesses can use it to offset payroll taxes or the alternative minimum tax. See, e.g., new IRC § 41(h). The expansions apply to tax years starting in 2016 and later. The expansion of the credit to the AMT applies to small businesses (those not publicly traded and that have annual gross receipts of less than \$50 million over the past three years). The expansion of the credit to offset payroll taxes permits qualified small businesses (those that are less than five years old and have less than \$5 million of gross receipts for the year) to elect to use up to \$250,000 of the credit to offset the employer portion of Social Security taxes (excluding the Medicare hospital insurance tax) in lieu of claiming it against the employer's income tax liability. The expansion should be of great benefit to many new and small businesses. Note that the IRS has issued interim guidance on the election to claim the payroll tax credit under section 3111(f). I.R.S. Notice 2017-23 (providing interim guidance on the term "qualified small business," and on how to make the payroll tax credit election and claim the credit).

Page 88: It is worthy to note that wages account for nearly seventy percent of total qualified research expenses. See Joseph Rosenberg, *3 Facts About the Research Tax Credit*, TAX NOTES TODAY, July 22, 2015, available at 2015 TNT 143-56. In IRS Field Attorney Advice 20171601F (Dec. 15, 2016), the IRS concluded that the method of allocating wages to determine the amount of its in-house research expense was improper. The IRS pointed out that wages incurred for an employee constitute in-house research expenses only to the extent the wages are incurred for qualified services performed, noting that if an employee performs both qualified and nonqualified services, only wages allocable to the qualified services counts. The regulations provide the method for determining in-house expenses in the absence of another more appropriate allocation method. In the field attorney advice, the taxpayer used its own method and not the method provided in Section 1.41-2(d). The IRS directed the taxpayer to use the method specified in the regulations.

Page 88: For a ruling that the taxpayer was not entitled to the section 41 credit because the requirements of section 174 were not met, see Priv. Ltr. Rul. 201718001 (Dec. 1, 2016).

Pages 88–90: For a recent Tax Court case sending a message that the research tax credit is meant to cover a broad range of innovation (both applied and basic science research), see *Suder v. Commissioner*, TC Memo 2014-201.

Pages 90–91: In January 2015, the IRS issued a new set of proposed regulations with respect to internal use software (applicable for tax years ending on or after January 20, 2015). In October 2016, the Treasury published final regulations (T.D. 9786) on the application of the research credit to internal-use software. They adopted, with some revisions, the proposed regulations published in January 2015. The 2016 final regulations clarify that software is developed for internal use if it is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's business. The final regulations also clarify that software is not developed primarily for the taxpayer's internal use if it is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties. The same is true for software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.

The 2015 proposed regulations provided a safe harbor applicable to dual function software. The 2016 final regulations modified the safe harbor applicable to dual function software to clarify that the safe harbor can be applied to the dual function software or the dual function subset after the application of section 1.41-4(c)(6)(vi)(B) of the final regulations.

The final 2016 regulations clarify that the internal use software rules do not apply to software developed for use in a qualified research activity. And they do not apply to a new or improved package of software and hardware developed together by the taxpayer as a single product. Thus the high threshold of innovation text discussed below would not need to be met for these. The high threshold of innovation test applies only to software developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's business, as well as to dual function software.

Page 91: The 2015 proposed regulations incorporated the high threshold of innovation test, and elaborate on each of the three prongs above for software: (1) it must be innovative, (2) its development must involve significant economic risk, and (3) it is not commercially available for use by the taxpayer. In a positive development, the 2015 proposed regulations stated that the first prong (innovative prong) “is not measured by the ‘unique or novel nature’ of the software but rather by ‘a measurable objective standard’ based on whether the software would result in substantially and economically significant cost or time savings.” See Amy S. Elliott, *Favorable Internal-Use Software Research Credit Regs Issued*, 2015 TNT 12-6 (Jan. 20, 2015). The 2015 proposed regulations stated the second prong (significant economic risk prong) “requires that, at the beginning of the taxpayer's activities, there be substantial uncertainty that the resources committed to the development of the software will be recovered within a reasonable period.” *Id.*

The 2016 final regulations are generally consistent with the 2015 proposed regulations. They clarify that the high threshold of innovation test applies only to software developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer trade or business and to dual function software. [The 2016 final regulations became effective October 4, 2016, i.e., are applicable for taxable years beginning on or after October 4, 2016. For any tax year that both ends on or after January 20, 2015 and begins before October 4, 2016, the IRS will not challenge return positions consistent with all of the 2016 final regulations or all of the 2015 proposed regulations.]

Page 92: In February 2015, the IRS published final regulations that adopt, with changes, earlier proposed regulations allowing taxpayer to elect the alternative simplified credit under section 41(c)(5) on an amended return. T.D. 9712 (eff. Feb. 27, 2015).

Page 93: In a recent summary opinion, the Tax Court held that a taxpayer, who explained that his business was “a business of intangible assets,” failed to adequately substantiate business expenses and deductions. *Boring v. Commissioner*, T.C. Summ Op. 2015-68.

Chapter 5

Taxation of Intellectual Property Acquisitions

Page 145: Neither the Internal Revenue Code nor the Treasury Regulations specifically address the tax treatment of domain name purchase costs. In a recent legal memorandum, however, the IRS did provide administrative guidance. In Chief Counsel Advice 201543014 (Sept. 10, 2015), the IRS first clarified that the cost of purchasing a domain name cannot be expensed under Section 162, but must be capitalized under Section 263. The IRS then addressed whether such capitalized purchase costs could be recovered over time through an amortization allowance.

The IRS concluded that a *non-generic domain name that functions as a trademark* is a Section 197 intangible amortizable over 15 years. [For purposes of Section 197, the term “trademark” “includes any word, name, symbol, or device, or any combination thereof, adopted and used to identify goods or services and distinguish them from those provided by others.” Domain names have dual functions. In addition to the technical function of locating a site on the Web, a domain name can function as a trademark if it is used to identify the source of goods or services.] The IRS also concluded that a *purchased generic domain name* does not meet the definition of a trademark under Treas. Reg. 1.197-2(b)(10), but is a “customer-based intangible” as defined in Treas. Reg. 1.197-2(b)(6) if: (a) the generic domain name is associated with a website that is already constructed and will be maintained by the acquiring taxpayer, and (b) such taxpayer acquired the generic domain name for use in its trade or business either to generate advertising revenue by selling space on the website or to increase its market share by providing goods or services through the website. Accordingly, such a generic domain name is a section 197 intangible amortizable over 15 years regardless of whether acquired as a separate asset or as part of the acquisition of a trade or business.

Chief Counsel Advice 201543014 assumes that the taxpayer is acquiring an already existing site but does not describe the tax results if the domain name was purchased from one that merely owned the name but was not using it. What if a taxpayer purchases a domain name outside of the secondary market or for reasons other than those discussed in the Chief Counsel Advice? What if a taxpayer purchases a generic domain name even though a website has not been constructed and no goods or services have been offered? The IRS should provide further guidance on the tax treatment of generic domain names.

Page 146: The section 179 expense deduction for off-the-shelf computer software has been made permanent by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act).

Chapter 6

Taxation of Intellectual Property Sales and Licenses

Page 176: A recent example of the difficulty in distinguishing a sale from a license is the case of *Myland, Inc. v. Commissioner*, T.C. Memo 2016-45, which involved a transfer of intellectual property rights in a chemical compound called nebivolol to a third party. The IRS argued that the proceeds from the transaction should be characterized as ordinary income from a license, whereas the taxpayer asserted that the proceeds resulted in capital gain from a sale. Because of substantial unresolved questions of fact, the court denied the IRS’s motion for summary judgment.

Page 184: For a recent private letter ruling illustrating section 1235’s application to limited liability companies and their members, see Priv. Ltr. Rul. 201701009.

Page 185: For a recent case holding that a pharmaceutical product developer did not transfer “all substantial rights” to technology he developed under a licensing agreement with a pharmaceutical company, see *Spireas v Commissioner*, T.C. Memo 2016-163 (holding royalties received were not subject to capital gains treatment under section 1235).

Page 186: It should be cautioned that proscribed control might be found even in the absence of a 25% stock ownership interest in the transferee. See *Cooper v. Commissioner*, 143 T.C. No. 10 (Sept. 23, 2014) (stating “retention of control by a holder over an unrelated corporation can defeat capital gain treatment under section 1235 because the retention prevents the transfer of ‘all substantial rights’”).

Page 188–189: Installment reporting is not available for an installment sale of depreciable property between related persons unless “it is established to the satisfaction of the Secretary of the Treasury that the disposition did not have as one of its principal purposes the avoidance of Federal income tax.” IRC 453(g)(1)-(2). See *Vest v. Commissioner*, No. 17-60026 (5th Cir. June 2, 2017) (holding that sales of computer equipment and intangible assets did not qualify for installment method because sales had a principal purpose of tax avoidance).

Page 191: For a recent case finding that the taxpayer did not establish basis in intangibles to a reasonable degree of certainty to claim an abandonment loss deduction, see *Washington Mutual, Inc. v. United States*, No. 1:08-cv-00321 (U.S. Court of Fed. Claims, Feb. 21, 2017).

Page 191: Similar to the *abandonment* loss deduction described in the main text, section 165 permits a deduction for loss arising from *theft*. In *Sheridan v. Commissioner*, T.C. Memo 2015-25 (Feb. 18, 2015), the taxpayer claimed a large deduction for theft losses that occurred when “pirates” stole the intellectual property underlying a patent that he held. The IRS disallowed the deduction because there was no evidence that patent infringement had occurred or that the taxpayer has incurred actual damages. The Tax

Court upheld the IRS's decision disallowing the theft loss deduction, finding that the taxpayer had failed to establish the section 165(e) theft loss requirements.

Chapter 7

Taxation of Intellectual Property Litigation

Page 230: In a recent Private Letter Ruling, the taxpayer licensed a certain patent from its affiliate for the manufacture and distribution of products based on the patent. Pursuant to the license agreement, the taxpayer was required to notify the affiliate about any third party violating the patent and the affiliates had complete control of the defense and related settlement negotiation with the third party. The taxpayer and the affiliate also agreed that they would share the expenses incurred in defending the patent, as well as proceeds recovered from the litigation. Later, the taxpayer filed a patent infringement against a company for infringing the patent. The company moved for a declaratory judgment of non-infringement and patent invalidity. None of the claims asserted that the affiliate did not have legal title to the patent. The taxpayer and the affiliate incurred expenses in legal costs. The Service concluded that the litigation costs incurred by the taxpayer are deductible as ordinary and necessary business expenses under Section 162(a) of the Code. According to the Service, the costs were incurred to protect against infringement of the patent by a competitor and not for the defense or perfection of title to the patent. Priv. Ltr. Rul. 201536006 (Sept. 4, 2015).

Page 230: In Chief Counsel Attorney Memorandum, AM 2014-006, 2014 WL 4495163, a generic drug manufacturer sought approval from the Food and Drug Administration for an Abbreviated New Drug Application (ANDA) with Paragraph IV Certification that allows for the testing and development of a generic drug prior to patent expiration. While making or using a patented drug in order to complete an ANDA is not an act of patent infringement, the act of filing an ANDA with Paragraph IV certification constitutes an act of patent infringement, providing courts with jurisdiction to resolve patent issues before actual sale of the generic drug. According to the IRS, the legal fees incurred in defense against patent infringement in relation to the ANDA application process are required to be capitalized under section 263 and Treas. Reg. § 1.263(a)-4(b)(1)(v), -4(d)(5). Capitalization is necessary because the infringement suit pursuant to an ANDA with Paragraph IV Certification is “so integral to the process by which generic drug manufacturers obtain approval to market and sell a generic version of a drug that the litigation costs to defend the suit are incurred ‘in the process of pursuing’ such approval.” The patent defense originates in a capital transaction—the application for FDA approval to market and sell a generic drug—and the costs of such litigation facilitate the transaction and must be capitalized under Treas. Reg. § 1.263(a)-4(e)(1). [Note: Where a drug manufacturer holds a patent on a drug for which an ANA with Paragraph IV certification is filed, the legal fees incurred by the drug manufacturer to establish the manufacture, use, or sale of the drug subject to the ANDA would infringe the drug manufacturer’s patent are generally not required to be capitalized under Treas. Reg. § 1.263(a)-4(d)(9).] Query: Do you agree with IRS’s position? Will it make it costlier for brand name and generic pharmaceutical companies to engage in patent litigation? In a more recent Field Attorney Advice, the IRS concluded that a drug manufacturer that filed an ANDA with the FDA must capitalize legal fees incurred in defending a patent infringement suit; the Service also concluded that FDA-approved ANDAs are section 197

intangibles that are amortizable ratably over 15 years. IRS Field Attorney Advice 20154502F (July 24, 2015).

Chapter 10

Taxation of Intellectual Property Held by Non-Profit Organizations

Page 342: Priv. Ltr. Rul. 201720010 (Feb. 22, 2017) (denying tax-exempt status to an organization established to support independent journalism initiatives because a substantial portion of its activities is providing services for a fee to co-op news organizations it helps set up); Priv. Ltr. Rul. 201717048 (Jan. 30, 2017) (denying tax-exempt status to an organization because it was formed for the non-exempt purpose of promoting a free and open-source software project); Priv. Ltr. Rul. 201710033 (Dec. 15, 2016) (denying tax-exempt status to an organization established to provide publishing and marketing services for authors and to advance religion by distributing products, finding that the organization operates primarily as a commercial printer); Priv. Ltr. Rul. 201643026 (Oct. 17, 2016) (ruling an organization whose purpose is to record and distribution the music of its artistic director failed to qualify for exempt status because it was not operating exclusively for one or more exempt purposes); Priv. Ltr. Rul. 201545028 (Aug. 12, 2015) (denying tax-exempt status to an organization established to fund the R&D of certain energy efficient devices because it operated for the private interest of its founder and his for-profit business); Priv. Ltr. Rul. 201538025 (June 25, 2015) (rejecting the exempt status of an organization whose activities are devoted to a non-exempt purpose of identification, development, promotion and sales of medical devices, in addition to serving the private interests of businesses and development partners); Priv. Ltr. Rul. 201545030 (June 22, 2015) (denying tax-exempt status to a record producer that would own rights to intellectual property pertaining to its projects).

For recent rulings denying tax exempt status to software organizations, see Priv. Ltr. Rul. 201717048 (Jan. 30, 2017) (denying tax-exempt status to an organization because it was formed for the non-exempt purpose of promoting a free and open-source software project); Priv. Ltr. Rul. 201514013 (Jan. 6, 2015) (denying tax exempt status to a company that provides software to businesses and nonprofit organizations as well as managerial and consulting services for a fee, because taxpayer's activities are commercial in nature and further the private interests of the founders); Priv. Ltr. Rul. 201507025 (Nov. 18, 2014) (denying tax-exempt status to a computer software developer that sought tax exempt status as a social welfare organization because developing and distributing open-source software does not promote the social welfare of a community and the developer's primary activity is selling software services at cost, similar to a for-profit company); Priv. Ltr. Rul. 201505040 (Nov. 6, 2014) (rejecting the exempt application submitted by an open source software organization that was formed for the purpose of creating, developing, and publishing open source software products for software programmers; such activities "do not serve a charitable class, further an educational purpose, or further a scientific purpose").

Page 343: In Private Letter Ruling 201644019, the IRS applied the royalty exception. In the ruling a non-profit organization licensed to a partnership certain of its trademarks, trade names, and other intellectual property (domain names and social media handles) in exchange for annual royalty payments. The IRS ruled that the payments constituted royalties excluded from the computation of unrelated business taxable income per section

512(b)(2). The IRS noted that this was consistent with Revenue Ruling 81-178, which is excerpted in the materials in the main text.

Page 345: In *Kaplan v. Commissioner*, T.C. Memo 2016-149, an artist contributed postcards of her own creation to non-profit organizations (the postcards included her printed name on the reverse side with a copyright symbol). She deducted a “thrift shop value” of \$1 for each. The court noted that the post cards were similar to inventory and therefore ordinary income property limited to a cost or basis deduction under section 170(e)(1)(A). Because the taxpayer could not provide a record of her cost or basis in the cards, she was not entitled to deductions for her postcard contributions. Interestingly, the court concluded that the postcards were inventory-type property. Even if they were not inventory, the result would have been the same under section 170(e)(1)(A), because self created works are not capital assets in the hands of their creator under section 1221(a)(3).

Chapter 11

Use of Domestic Intellectual Property Holding Companies

Page 381: The Maryland Court of Appeals in *NIHC, Inc. v. Comptroller of Treasury*, 97 A.3d 1092 (Md. App. 2014), offered the following observation about the modern day holding company scheme to avoid state taxation by comparing the scheme to the basketball maneuver known as the “four corners offense:”

Once upon a time, before the advent of the shot clock, some basketball teams employed a maneuver known as the “four corners offense.” This strategy involved a series of passes among team members that seemingly did not advance the ultimate purpose of putting the ball in the hoop, but had the separate purpose of depriving the opposing team of possession of the ball. In a somewhat analogous enterprise, corporate tax consultants devised a strategy that involved a series of transactions passing licensing rights between related corporations and that was motivated by a desire, not to directly enhance corporate profits, but to keep a portion of those profits out of the hands of state tax collectors. Much as the shot clock led to the demise of the four corners offense, judicial decisions during the past two decades have limited the utility of this tax avoidance strategy.

Chapter 12

Overview of International Taxation

Page 421: The United States has the highest corporate income tax rate among OECD nations. It has been suggested that the United States adopt a so-called “patent box,” which would provide a lower tax rate solely on income generated by patents and/or other types of intellectual property. Several countries in the European Union (e.g., Belgium, France, Hungary, Luxembourg, the Netherlands, and Spain) have some form of patent or innovation box.

Chapter 13

Use of Foreign Intellectual Property Holding Subsidiaries

Page 461: See Gabe B. Gartner, *(Ir)recoverable Basis in Outbound Intangible Transfers*, 2015 TNT 91-15 (May 12, 2015) (arguing that until the tax treatment of tax basis in outbound transfers of intangible property is clarified by regulations or other guidance, taxpayers should not assume that their tax basis is irrecoverable).

Page 461: Under an earlier rule, the useful life of intangible property was limited to 20 years. Treas. Reg. §1.367(d)-1T(c)(1), (3). However, in December 2016, the IRS published final regulations that adopted 2015 proposed regulations (and some temporary regulations published in 1986). Consistent with the 2015 proposed regulations, the 2016 final regulations eliminate the 20-year limitation on useful life for some intangible property subject to section 367(d). So, now the useful life of intangible property is the entire period during which the exploitation of the intangible property is reasonably anticipated to occur, as of the time of the transfer. The final regulations, however, restore the 20-year limitation when the useful life of the transferred property is indefinite or is reasonably anticipated to exceed 20 years. According to the government, the 20-year life provision was an arbitrary cap on the life of an intangible, and its elimination allows for a better measure of the value of intangibles.

Page 461: Under a 1986 temporary regulation, Section 367(d) applied to the transfer of any intangible property, but not to the transfer of *foreign goodwill or going concern value* (foreign goodwill exception). Treas. Reg. 1.367(d)-1T(b), -1T(d)(5). In September 2015, the IRS issued proposed regulations that eliminated the foreign goodwill exception. The government was concerned that in outbound transfers some taxpayers tried to avoid gain recognition by asserting most of the value of property transferred was foreign goodwill or going concern value eligible for favorable treatment. The government was also concerned that some taxpayers broadly interpreted the meaning of foreign goodwill and going concern. In December 2016, the IRS published final regulations that adopt, with some changes, the 2015 proposed regulations. The final regulations eliminate the favorable treatment of foreign goodwill and going concern value under the 1986 temporary regulations. According to the government, the final regulations were not issued because of government opposition to favorable treatment for goodwill and going concern value, but instead because of fundamental disagreements over what constitutes goodwill and going concern value versus other intangibles. Alexander Lewis, *Outbound Transfer Regs Meant to Distinguish Types of Intangibles*, 2017 TNT 14-14 (Jan. 24, 2017).

Pages 462–464: It should be noted that Ireland, under pressure from European countries, recently changed its tax residency rules as of January 2015, so that all Irish-registered companies must be tax residents in Ireland within the next six years. More specifically, although new companies can no longer use the “Double Irish” structure, existing companies have until the end of 2020 to come into compliance with the new law. Thus, the material that follows remains relevant for some time for a good number of existing schemes. Ireland has retained its low 12.5% corporate tax rate, so it remains to be seen

whether Ireland will remain attractive for companies. In addition to the grandfathering exception discussed above (applicable to existing companies incorporated in Ireland and resident in a non-treaty jurisdiction, like Bermuda), there is a treaty based exception as well. Companies incorporated in Ireland and managed and controlled in a treaty jurisdiction, like Malta or Hong Kong, are not deemed to be tax residents of Ireland IF a treaty tie-breaker rule enforces the other country as place of tax residency. This treaty exception to the revised residency rule opens up several possibilities to achieve similar results by moving the managerial headquarters of a controlled subsidiary into a country with a treaty with Ireland.

Page 462–464: The main text describes several anti-deferral provisions applicable to U.S. companies that use foreign corporations to avoid or defer U.S. tax. Many of these anti-deferral provisions, however, can be avoided with careful tax planning.

The U.S. *controlled foreign corporation rules (subpart F)* impose current taxation on passive income (e.g., dividends and royalties from lower tiered CFCs to higher-tiered CFCs) and on certain active income. But multiple exceptions and loopholes are available that undercut the intended application of subpart F. Importantly, the check-the-box regulations enable U.S. multinational companies to have lower-tiered CFCs disregarded for U.S. tax purposes, so passive income paid to higher-tiered CFCs is ignored by the United States (not subpart F income). [Note that a temporary CFC look-through rule was enacted in 2006, which provides “look through” treatment for payments between related CFCs; the provision has been temporary, so multinational companies still rely heavily on check-the-box.] In addition, the CFC rules themselves contain important statutory exceptions. For example, the “same country” exception excludes payments from one related CFC to another in the same country. [Note that, in addition, a manufacturing exception exists that excludes income if the CFC itself manufactures the goods it sells; regulations make it easy to claim this exception.]

The *transfer pricing rules of Section 482* use an “arm’s-length” approach to transfer pricing concerns. As described earlier, the United States requires royalties be “commensurate with the income” attributable to transferred intellectual property, and the IRS is allowed to make periodic royalty adjustments years after the intellectual property transfer, even if the initial royalty was reasonable when set. U.S. multinational companies have found ways to avoid transfer pricing adjustments by entering into cost sharing agreements with their foreign subsidiary corporations. Cost sharing arrangements are expressly authorized by the regulations. Under a cost sharing agreement, a U.S. multinational company and its foreign subsidiary share R&D costs and risks of co-developing products for a global market in exchange for rights to intellectual property for their respective markets. Because the economic ownership of newly developed intangibles is split, no arm’s-length royalty payments are needed for the use of intellectual property. It should be noted that an arm’s-length buy-in payment is required for platform contributions made by U.S. multinationals.

Techniques used by multinational companies to circumvent anti-deferral rules (e.g., utilization of check-the-box regulations to create hybrid entities, the use of cost sharing arrangements to avoid transfer pricing adjustments) may be legal but they are circumventing the purposes of the laws. Many governments, including the United States,

have taken note of these intellectual property income shifting techniques and their impact on domestic revenue bases. According to one analysis, income shifting from the United States to low tax jurisdictions drains as much as \$100 billion in corporate revenue from the United States every year. Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, Jan. 2016, available at SSRN-id2685442.pdf. The Joint Committee on Taxation itself estimates the loss for FY 2016 to be \$108.9 billion. Joint Committee on Taxation, *Estimates of Federal Tax Expenditure*, JCS-141R-15, Dec. 7, 2015, available at www.jct.gov/publications.html?func=select&id=5. It is also estimated that U.S. multinationals have now accumulated nearly \$2.3 trillion of un-repatriated earnings in 2014. Audit Analytics, *Untaxed Foreign Earnings Top \$2.3 Trillion in 2014*, Apr. 2015, available at www.auditanalytics.com/blog/untaxed-foreign-earnings-toop-2-3-trillion-iin-2014/.

In the United States, members of Congress from both parties have put forth various tax reform proposals. The White House and the Treasury Department have released “The President’s Framework for Business Tax Reform,” which targets income shifting. *The President’s Framework for Business Tax Reform: An Update*, Apr. 2016, available at www.treasury.gov/resource-center/tax-policy/Documents/The-Presents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf.

Other countries around the world are also looking hard at what multinationals are doing and discussing measures to close tax loopholes. Most notably, at the request of the G-20 nations, the Organization for Economic Cooperation and Development (OECD) in 2015 delivered a number of recommendations on how to deal with base erosion and profit shifting (BEPS Project). See OECD, BEPS 2015 Final Reports, Oct. 5, 2015, available at www.oecd.org/tax/beps-2015-final-reports.htm. The final BEPS Project reports, issued in October 2015, make concrete action plan recommendations to help nations address the problems of income shifting. Most recommendations attempt to tax profits where value is added and to promote greater tax transparency with increased information exchange between tax authorities.

The OECD points out the advantages of a multilateral approach to international tax reform. It will be interesting to see how countries address the OECD’s recommendations, as countries have different goals and face different constraints. There are signs that the United States intends to meet the multilateral commitment it made in the OECD’s BEPS Project. For example, the Treasury and the IRS have recently published final regulations that require annual country-by-country reporting by U.S. multinationals that are the ultimate parent entity of a multinational enterprise group with annual revenue for the preceding accounting period of \$850 million or more—as recommended in BEPS Action Plan #13 (transfer pricing documentation).

Page 465: Recent years have seen numerous corporate inversions. For an explanation for the recent tide of inversions, see Robert Holo & Devin J. Heckman, *Inversions Inside Out*, 2014 TNT 241-7 (Dec. 2, 2014) (describing the benefits and risks associated with modern inversion transactions, and discussing recent proposals to address inversion strategies). The U.S. government has taken several steps in recent years to prevent corporate inversions. Specifically, the IRS issued an IRS Notice in 2014, an IRS Notice in 2015, and Treasury Regulations in 2016 (finalized in 2017 with T.D. 9812).

Chapter 14

Transfer Pricing and Cost Sharing Arrangements

Page 477: A number of high profile transfer pricing disputes under section 482 continue to arise, but the government has lost a number of them. Medtronic, Inc., for example, has been involved in a high profile dispute in Tax Court involving more than \$2 billion in proposed section 482 transfer pricing adjustments. The Tax Court, recently held that Medtronic’s comparable uncontrolled transaction method, with appropriate adjustments by the court, should be used to determine royalty rates for licensing of intangibles for devices and leads between Medtronic and its Puerto Rican subsidiary. *See* Medtronic Inc. et al. v. Commissioner, T.C. Memo 2016-112 (June 9, 2016). Settlements are not uncommon. Examples include government transfer pricing disputes with Guidant LLC and Caterpillar.

Page 478–479: In *Medtronic Inc. v. Commissioner*, T.C. Memo 2016-112, the Tax Court held that the CUT method, with appropriate adjustments by the court, should be used to determine royalty rates for licensing of intangibles for devices and leads between Medtronic and its Puerto Rican subsidiary. The court ruled that the use of another method—the comparable profits method, was not required and its allocations of income were unreasonable.

Page 484–485: In 2017, the Tax Court rejected the IRS’s method for determining the buy-in payment between Amazon.com Inc. and a European subsidiary for the transfer of preexisting intangibles to the subsidiary and rejected the IRS’s deamination that 100% of technology and content costs constitute intangible development costs. *See* Amazon.com Inc. v. Commissioner, 148 T.C. No. 8 (Mar. 23, 2017), available at 2017 TNT 56-11 (Mar. 24, 2017). The court found that the IRS abused its discretion when it determined that the buy-in payment should be increased. The court found that the appropriate method was Amazon’s CUT method but found that Amazon failed to prove its proposed valuation met the arm’s-length standard. The Tax Court, using the CUT method, determined the appropriate buy-in payment for each type of intangible asset—website technology, marketing intangibles, etc.—that Amazon U.S. made available to the foreign subsidiary. *Id.*

Page 486: *See* Mark J. Silverman, et. al, *Considering Veritas and Future Transfer Pricing Litigation*, 2014 TNT 200-6 (Oct. 16, 2014) (examining the IRS’s continued efforts in litigation despite the Tax Court’s rejection of the IRS’s position in *Veritas*).

Page 487: According to an IRS report, 86 APAs were executed in 2016 compared with 110 in 2015. IRS Announcement 2017-3, 2017-15 I.R.B. 1 (Mar. 27, 2017).

Page 484: The saga of stock-based compensation in cost sharing arrangements has continued. After the Tax Court’s 2010 decision in *Xilinx* (which held that under the 1995 cost-sharing regulations, stock-based compensation costs need not be shared between controlled entities entering into cost sharing arrangements), the Tax Court in 2015

addressed the 2003 regulations (which required participants in a cost sharing arrangement to share stock-based compensation costs). In *Altera Corp. v. Commissioner*, the Tax Court invalidated, as arbitrary and capricious, the 2003 regulation that required participants in a cost sharing agreement to share the costs of stock-based compensation in order to achieve an arm's-length result. 145 T.C. No. 3 (July 27, 2015). The issue in the case was whether the U.S. taxpayer, under its cost sharing arrangement with its foreign subsidiary, failed to include stock-based compensation in its cost-share pool, resulting in insufficient income allocated to the United States. The IRS increased the foreign subsidiary's cost-sharing payments, allocating more income to the U.S. taxpayer. According to the court, the government could not have rationally adopted the regulation based on its consistency with the arm's-length standard, and the government did not contend that the regulation had been adopted solely based on the "commensurate with income" standard. See Michael L. Schler, *The Arm's-Length Standard After Altera and BEPS*, TAX NOTES TODAY, Dec. 1, 2015, available at 2015 TNT 230-9. The government has appealed its loss in *Altera* to the Ninth Circuit.

Chapter 15

Estate Planning for Intellectual Property

Page 543: With the recent death of several celebrities, the valuation of postmortem rights of publicity for estate tax purposes has gained particular attention. *See, e.g., Marie Sapirie, But Honey I'm Rich on Personality: Publicity Rights and Estate Taxes*, TAX NOTES TODAY, May 5, 2016, *available at* 2016 TNT 89-2.

Page 543: In 2017, an unmarried decedent's estate of less than \$5,490,000 escapes any federal estate tax if the decedent made no lifetime taxable gifts.

Page 546: The IRS has recently published proposed regulations that require an heir's basis in property acquired from a decedent to be consistent with the value of the property as finally determined for estate tax purposes. REG-127923-15; 81 Fed. Reg. 11486-11496 (Mar. 4, 2016).

Page 548: One option for a client is to securitize future royalty income. Securitizing royalty income can provide funds for the decedent's estate to pay estate taxes without the estate having to sell the intellectual property rights. *See Ajay Gupta, David Bowie: Rock Star of Tax Planning*, TAX NOTES TODAY, Jan. 14, 2016, *available at* 2016 TNT 11-4.