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# Intellectual Property Taxation: Problems and Materials

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## Chapter 1
## Introduction

**Page 6:** A challenge for anyone dealing with the subject of tax is that the Internal Revenue Code is constantly changing. Most recently, Congress enacted the Tax Cuts and Jobs Act (TCJA) in December of 2017. This act made numerous changes to the Code as it applies to individuals, corporations, and pass-through entities such as partnerships and LLC's. Many of these changes impact intellectual property owners. The changes wrought by the TCJA are largely effective as of January 1, 2018. There are exceptions, however. For example, the TCJA's replacement of the research and development deduction with a five-year write-off rule does not become effective until 2022.

## 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, 573 U.S. 208 (2014). In *Alice Corp.*, the Court rejected the patentability of a method relating to a formation and trading of risk management contracts. The Court held that the invention was an abstract idea. The Court mandated a two-part test: (1) determine whether the claims are directed to a patent-ineligible concept, such as an algorithm, method of computation, general principle, or abstract idea; and (2) determine whether the claim's elements transform the claim into patent eligible concept. The *Alice* decision renders many software inventions patent ineligible.

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

**Page 17:** In 2016, the federal government enacted the Defend Trade Secrets Act ("DTSA") harmonizing state law on trade secrets and extending nationwide protections against misappropriation of trade secrets. Trade secret owners can sue in federal court when the trade secret misappropriation is related to a product or service used in or intended for use in interstate or foreign commerce. Under the DTSA, trade secrets cover "all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing …" 18 U.S.C. § 1839.

**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 18:** Under the federal DTSA, owners of trade secrets may request an ex parte seizure order to prevent further propagation or dissemination of the trade secret. Federal law allows injunctive relief to prevent any actual or threatened misappropriation of trade secrets and money damages, which include (i) actual damages, (ii) unjust enrichment, or a (iii) reasonable royalty. Federal remedies under the DTSA do not preempt state law where a state may provide additional forms of relief.

**Page 20:** 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). In a major victory for the fashion industry, the Supreme Court in Star Athletica v. Varsity Brands, 137 S. Ct. 1002, 1012 (2017), extended copyright protection for clothing designs. The Court held that a feature of the design of a useful article is eligible for copyright "if, when identified and imagined apart from the useful article, it would qualify as a pictorial, graphic, or sculptural work either on its own or when fixed in some other tangible medium."

**Page 23:** In addition to copyright law, patent protection may be available if the software or computer-related method invention can satisfy the two-part test required in *Alice v. CLS Bank* mentioned above. In recent years, few software inventions were qualified for patent protection.

## Chapter 3
## Overview of Traditional Principles of Federal Income Taxation

**Page 54:** As will be explained in a later chapter, the Tax Cuts and Jobs Act of 2017 (TCJA) created a new temporary deduction for certain business owners under new section 199A.

**Page 57:** Section 11 provides the flat rate that applies to subchapter C corporations, which—like estates and trusts—are treated as separate taxpaying entities. For tax years beginning in 2018, the corporate income tax imposed by section 11(a) is a flat 21% of taxable income, which is significantly lower than the highest individual marginal rates. IRC § 11(b). Prior to 2018, a graduated corporate tax rate structure, with a top rate of 35%, existed. The TCJA eliminated the graduated rate structure and enacted a 21% flat rate to spur economic growth and jobs creation, and to make U.S. companies globally competitive.

In contrast to the flat rate for corporate taxpayers, the schedule of tax rates for individual taxpayers is progressive or graduated, which means that as income increases an individual's tax liability also increases, but at a greater rate. The rate of tax at each bracket level is called the marginal rate of tax. For tax years beginning in 2018, there are seven tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

**Page 57**: Currently, the maximum rate at which most long-term capital gains are taxed is 15% (0% for low income taxpayers and 20% for high income taxpayers). The taxable income breakpoint between the 0% and 15% rates is $38,600 for unmarried individuals ($77,200 for joint filers). The breakpoint between the 15% and 20% rates is $425,800 for unmarried individuals ($479,000 for joint filers). IRC § 1(j)(5)(B). These breakpoints are indexed for inflation after 2018. IRC § 1(j)(5)(C). Therefore, in the case of a single taxpayer with adjusted net capital gain in 2018, to the extent the gain would not result in taxable income exceeding $38,600, such gain is taxed at 0%. To the extent the gain would result in taxable income exceeding $38,600 but not exceeding $425,800, the gain is taxed at 15%. To the extent the gain would result in taxable income exceeding $425,800, the gain is taxed at 20%.

**Page 60:** In 2021, the AMT 28% rate begins at $199,900 for all married taxpayers ($99,950 for unmarried individuals). For 2021, the exemption amounts were $73,600 for unmarried individuals and $114,600 for joint filers. These exemptions are phased out for high income taxpayers. The AMT was was repealed for corporate taxpayers in the TCJA.

## 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.

In 2014, the IRS and Treasury issued final regulations addressing capitalization and allocation of sales-based royalties. T.D. 9652. The final regulations made an allocation optional, permitting taxpayers to either allocate sales-based royalties entirely to property sold (include costs in cost of goods sold) or allocate sales-based royalties between cost of goods sold and ending inventory. In short, the final regulations allow the allocation of sales-based royalties to property sold to be optional rather than mandatory

**Pages 79-80:** Prior to 2018, businesses could qualify for an exception to the uniform capitalization rules for personal property *purchased for resale* if the business had average annual *gross receipts of $10 million or less* for the preceding three tax years. IRC § 263A(b)(2). The Tax Cut and Jobs Act (TCJA) expanded the gross receipts test to $25 million. In addition, it expanded the exception to apply not only to taxpayers that purchase personal property for resale but also to any *producer* or *reseller* that meets the $25 million gross receipts test. IRC § 263A(i). The TCJA retained the exemptions from the uniform capitalization rules that are not based on gross receipts, such as the exemption for qualified creative expenses discussed in this chapter.

**Page 80:** The section 181 election was extended recently and applies to productions commencing before January 1, 2026. Taxpayer Certainty and Disaster Tax Relief Act of 2020, P.L. 116-260, § 116(b). With respect to film or television shows, a production commences on the date of fist principal photography. With respect to live theatrical productions, a production commences on the date of the first public performance before a playing audience. If an election is made, production costs are expensed in the year in which such costs are first paid or incurred, and not later when the production is placed in service (which is the case if the bonus depreciation option (discussed below) is chosen. Treas. Reg. § 1.181-2(b). However, if an election is made, section 181 limits deductions for production costs to $15 million ($20 million for costs in designated low-income or distressed areas). Any excess costs above the threshold can be expensed using the bonus depreciation rules discussed below (once the "placed in service" standard is met). [NOTE: An election must be made under section 181. *See* Kantchev v. Commissioner, T.C. Memo 2015-234 (holding than an individual was not entitled to claim losses from his S corporation's production of a film because no election was made under section 181 to allow the deduction of the film production costs).]

**Page 80:** *Bonus Depreciation Option*. To help stimulate the economy, Congress in the TCJA enacted a temporary provision that provides an extra, up-front depreciation deduction for "qualified property." Through 2022, section 168(k) of the Code authorizes a taxpayer to deduct 100 percent of the cost of qualified property—*which includes section 181 property (e.g., certain television programs, films and live theatrical productions*—as depreciation in the year of acquisition. The extra depreciation deduction is scheduled to gradually phase out beginning in 2023 and completely sunset in 2027; more specifically, starting in 2023, expensing will phase down by 20 percentage points for each of the following four years. Section 181 previously allowed taxpayers to elect to expense costs of films, television programs, and live theatrical production costs so long as 75% of the compensation costs were incurred in the United States.

The bonus depreciation (100% expensing) applies to qualified film, television and live theatrical productions for which a deduction would otherwise have been allowable under section 181 (see above), without regard to the $15 million expensing limit or the December 31, 2017, expiration date. IRC § 168(k)(2)(A)(i), as amended by the TCJA. Note that there is no cost limit for bonus depreciation under section 168(k). In other words, the $15 million limitation ($20 million in some cases) does not apply. Note further that production costs are recovered, not when costs are incurred as under section 181, but when the property is placed in service (defined in section 168(k)(2)(H) as the date of initial release, broadcast or staged performance).

Section 168(k) 100% bonus depreciation begins for section 181 property that is acquired and placed in service after September 27, 2017. Procedurally, a section 181 election is not necessary for property to satisfy the definition of "qualified property" for section 168(k) bonus depreciation purposes. An election can be made out of bonus depreciation under section 168(k)(7).

In short, there are currently two options for expensing qualified film, television, and live theatrical production costs—section 181 and section 168(k). Both are temporary provisions. In choosing between section 181 and section 168(k), advisors should examine a client's state income tax laws. Some states piggy back the federal tax law and recognize section 181 deductions for state income tax purposes, but some do not. Further, not all states piggy back the federal bonus depreciation rules in section 168(k).

**Pages 80-81**: Hobby expenses are classified as miscellaneous itemized deductions. Treas. Reg. § 1.67-1T(a)(1)(iv). Prior to 2018, miscellaneous itemized deductions were deductible only if, and to the extent, they exceeded 2% of the taxpayer's adjusted gross income (AGI). IRC § 67(b). Starting in 2018 and continuing through 2025, however, the TCJA completely eliminated miscellaneous itemized deductions. IRC § 67(g). This means that, at least temporarily, intellectual property creators will not be able to deduct expenses from their hobbies but will still have to report any income they earn from their hobbies. While this may seem unfair, keep in mind that taxpayers still get to deduct expenses that would be allowable whether or not an activity is engaged in for profit (e.g., state and local property taxes, which are itemized deductions and not miscellaneous itemized deductions). Also the TCJA roughly doubled the standard deduction, which somewhat makes up for the temporary repeal of the hobby loss deduction. Nevertheless, the TCJA raised the stakes for intellectual property creators by making the basic question of whether a creative activity is a hobby or not a hobby crucial to getting nearly any deduction.

**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); Lewis v. Commissioner, T.C. Memo 2017-117 (disallowing deduction of writing expenses by a minister because he lacked a profit motive).

For recent cases involving musicians, see Nicholson v. Commissioner, T.C. Summ. Op. 2018-24 (Apr. 18, 2018) (holding that an engineer was not entitled to many of the deductions he claimed for his music activities); Ford v. Commissioner, T.C. Memo 2018-8 (holding that a former country and western recording artist who retired and established a music club was engaged in a hobby; the taxpayer had a history of losing money, did not keep adequate records, did not follow business advice, and derived pleasure mingling with artists).

**Page 81:** [NOTE: For tax years beginning after December 31, 2021, research and experimental expenditures must be capitalized and amortized over five years. IRC § 174, as amended by the TJCA. For now, taxpayers may continue to expense such items under section 174. Some commentators believe that the law change is more about meeting revenue goals of the TCJA than expected permanent legislation. Only time will tell. The material in Chapter 4 still reflects current law until 2022.]

**Page 82:** In Bradley v. Commissioner, T.C. Summ. Op. 2018-33, the Tax Court recently denied a litigation consultant's attempt to expand the definition of deductible research and experimentation expenses to include legal research. The court pointed out that research expenditures deductible under section 174 "are those incurred in the experimental or laboratory sense." In *Bradley*, the taxpayer deducted $25,000 for pro bono legal research (100 hours @ $250 hourly rate). The court also took issue with the fact that the taxpayer never "paid or incurred" costs; and, without an outlay of money, his time did not fall under the statute.

**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 in the book 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. The shrinking back provision recognizes situations in which component costs can qualify even though basic design specifications of the product are certain. T.D. 9680 (eff. July 21, 2014).

**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 85:** As noted above, the TCJA repeals section 174(a) (immediate expensing) beginning in 2022. At that point, specified research experimental expenditures (including software development costs) must generally be amortized ratably over a five-year period.

**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.*, 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).

The Tax Cuts and Jobs Act of 2017 (TCJA) did not substantially alter the research 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 used by the taxpayer 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. For a recent article suggesting that taxpayers often don't claim the research tax credit because they believe they aren't developing anything new, see Grant Rollins, *The Research Credit's Smell Test*, available at TAX NOTES, Nov. 13, 2017, at 947.

**Page 90:** Qualified research does not include research to the extent funded by grant, contract, or otherwise by another (including the government). I.R.C. § 41(d)(4)(H). The Code does not define the term "funded," but the regulations provide guidance. Treasury Regulations Section 1.41-4A(d) provides that research is funded under either of two circumstances. First, research is funded if the taxpayer receives payment that is not "contingent on the success of the research." Second, research is funded if the taxpayer performing research for another person or governmental entity "retains no substantial rights" in the research. For recent cases, see Geosyntec Consultants, Inc. v. United States, 776 F.3d 1330 (11th Cir. 2015) (holding an engineering firm was not entitled to research credits on grounds that the resea4ch was funded by the taxpayer's clients); Dynetics, Inc. v. United States, No. 12-576T (Fed. Cl. May 31, 2015) (holding that research was funded because payment was not contingent on the success of the research and the company did not retain substantial rights in the research results).

**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 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 date 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. The general rules for software (including whether software is external or internal use) should apply to the development of software related to cryptocurrencies like bitcoin. *See* Nathan J. Richman, *Cryptocurrency Raises Conventional and Novel R&D Questions*, available at TAX NOTES, May 14, 2018, at 1058.

**Page 91:** The 2015 proposed regulations incorporated the high threshold of innovation test, and elaborated 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:** On March 27, 2018, the Treasury released final regulations on the allocation of the controlled group research credit. T.D. 9832 (effective April 2, 2018); 83 F.R. 13183-13185, 2018-16 I.R.B. 477. They do not deviate from the earlier temporary regulations. Under the final regulations, controlled group members who are also members of a consolidated group are treated as a single member. The group credit portion allocated to a consolidated group is allocated to each member in proportion to its share of the aggregate of the qualified research expense.

**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). It should be noted that the Tax Cuts and Jobs Act of 2017 (TCJA) enacted a temporary provision that provides an extra, up-front depreciation deduction for qualified property. Through 2022, section 168(k) authorizes a taxpayer to deduct 100% of the cost of qualified property as depreciation in the year of acquisition. Qualified property includes off-the-shelf software. *See* Gary Guenther, *The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects, Congressional Research Service*, at 3-4 (May 1, 2018), available at https://fas.org/sgp/crs/misc/RL31852.pdf. This deduction is computed after applying section 179 (if it was elected) and before the regular depreciation deduction is calculated for the year. The extra depreciation deduction is scheduled to gradually phase out for purchases beginning in 2023 and completely sunset in 2027 (100% remains in effect through 2022; it is scheduled to decrease to 80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and 0% for property acquired and placed in service in 2027 and thereafter).

**Page 150:** In the chart "Cost Recovery Deductions for Acquired Software," note that, in addition to section 179, section 168(k) temporarily permits up-front depreciation for qualified property, which includes off-the-shelf software.

## Chapter 6
## Taxation of Intellectual Property Sales and Licenses

**Page 175:** It should be noted that the Tax Cuts and Jobs Act of 2017 (TCJA) made numerous changes that impact intellectual property transfers. The leading theme of the new law is an across-the-board reduction of tax rates (at least temporarily). The changes wrought by the TCJA are largely effective as of January 1, 2018. Nearly all of the changes to the *individual* income tax are temporary and expire on January 1, 2026. At this point, it is impossible to predict which, if any, of those changes will continue in effect after that date. Unlike the individual income ax changes, the *corporate and pass-through entity* tax changes are permanent (at least in the sense of having no expiration date).

TCJA changes that impact intellectual property sales, exchanges, and licenses are addressed below.

**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 178:** Under the TCJA, like-kind exchanges are not allowed for intellectual property after 2017. Like-kind exchanges are allowed only for *real property* after 2017. IRC § 1031(a), as amended by the TCJA. Thus, gain or loss realized will now be recognized upon the exchange of intellectual property for other intellectual property.

[Note: The newest alternative to the like-kind exchange rules relates to investments in qualified opportunity zones, created by the Tax Cuts and Jobs Act of 2017 (TCJA). Basically, investors can defer tax on capital gain (from a sale to an unrelated person) through December 31, 2026, by making an investment in a qualified opportunity zone—i.e., by making an equity investment in a qualified opportunity fund (QOF). I.R.C. § 1400Z-2. QOFs are beyond the scope of this text.]

**Page 179:** For individuals, current income tax rates on ordinary income are 10%, 12%, 22%, 24%, 32%, 35%, and 37%. By contrast, the rates on net capital gains are much lower—generally 0%, 15%, or 20% in most cases. The applicable capital gains rate depends on the taxpayer's income level. The taxable income breakpoint between the 0% and 15% rates is $38,600 for unmarried individuals ($77,200 for joint filers). The breakpoint between the 15% and 20% rates is $425,800 for unmarried individuals ($479,000 for joint filers). IRC § 1(j)(5)(B). These breakpoints are indexed for inflation after 2018. IRC § 1(j)(5)(C). Therefore, in the case of single taxpayer with adjusted net capital gain in 2018, to the extent the gain would not result in taxable income exceeding $38,600, such gain is taxed at 0%. To the extent the gain would result in taxable income exceeding $38,600 but not exceeding $425,800, the gain is taxed at 15%. To the extent the gain would result in taxable income exceeding $425,800, the gain is taxed at 20%.

Consider the following example. In 2018, Taxpayer has ordinary taxable income of $100,000 and a "net capital gain" of $10,000 from the sale of intellectual property. Taxpayer's ordinary income of $100,000 is already between the 15% breakpoint of $38,600 and the 20% breakpoint of $425,800. Because the $10,000 of capital gain would not cause total taxable income to exceed $425,000, it is taxed at 15%.

[Note: Ordinary losses (in contrast to capital losses) are generally deductible in full. If, however, a taxpayer's business deductions exceed its gross income, this creates what is known as a "net operating loss" or NOL. Prior to 2018, an NOL was carried back two years and then carried forward 20 years to offset taxable income in the carryback and carryforward years. IRC § 172. Under the TCJA, NOLs arising in a tax year ending after 2017 are generally not allowed to be carried back but may only be carried forward indefinitely. In addition, under the TCJA, NOLs may only reduce 80 percent of a taxpayer's taxable income in a carryforward year. (Note the Coronavirus Aid Relief and Economic Security (CARES) Act made additional changes for years 2018, 2019, and 2020.)]

**Page 181-182**: *Exception for Self-Created Copyrights and Similar Property*. Prior to 2018, patents were deliberately not included within this exclusion for self-created property and, hence, were entitled to capital gain treatment under general characterization principles. However, the TCJA expanded the capital asset exclusion of section 12221(a)(3) to include self-created patents. The definition of capital asset now also excludes a patent, invention, model or design, a secret formula or process held by the creator (taxpayer whose personal efforts created the property). More specifically, in the case of dispositions after December 31, 2017, a patent, invention, model or design (patented or not), or secret formula or process is not a capital asset in the hands of (1) the taxpayer whose personal efforts created the property, or (2) a taxpayer with a substituted or transferred basis from the taxpayer whose personal efforts created the property. IRC § 1221(a)(3), as amended by the TCJA. Thus gains and losses from the sale or exchange of a self-created patent or similar property will not be capital gains or capital losses, unless a special characterization provision applies.

On this point, one should note that although patents are excluded from the definition of capital asset, a qualified holder's gain on the disposition of a patent to an unrelated person may still be eligible for capital gains treatment under section 1235, a special characterization rule discussed in the next section.

**Page 182:** *Application of the Exclusion to Property That Is Both Patentable and Copyrightable.* The application of the section 1221(a)(3) exclusion to property that is both patentable and copyrightable is no longer uncertain. That is because the TCJA added self-created patents to the list of assets excluded from the definition of capital asset. In other words, for dispositions in 2018 and thereafter, self-created patents, as well as self-created copyrights, are not entitled to capital gains/loss treatment under general characterization principles.

**Page 183:** Recall that the Tax Cuts and Jobs Act of 2017 (TCJA) amended section 1221(a)(3) so that patents and inventions created by the personal efforts of a taxpayer disposing of them are not capital assets, and, thus, generate ordinary gain or loss under general characterization principles. Interestingly, Congress did not repeal section 1235 which can provide long-term capital gain treatment to essentially the same property.

Many commentators have suggested Congress created a conundrum (and anomalous result) when it failed to change section 1235 in conjunction with its amendment of section 1221(a)(3). The TCJA was enacted quickly and the failure to repeal section 1235 may have fallen between the cracks. Congress has had a chance to correct the omission in subsequent legislation, but it has not. For now, individual inventors can claim capital gain treatment for their self-created patents provided all the requirements of section 1235 (a special characterization provision) are met

**Pages 183-184:** It is often common for university employees to transfer patent rights to their employer-universities in exchange for a percentage of the employer's future licensing revenue (i.e., a royalty sharing agreement or RSA). And often, section 1235 provides long-term capital gain treatment for such employees.

When payments from an RSA are made to the employee's "research account," however, unexpected tax consequences can arise. *See* Benjamin A. Davidson, Brittany G. Cvetanovich & A.L. Spitzer, *"Just Put It in My Research Account": Transfers of RSA Rights*, available at TAX NOTES, Dec. 18, 2017, at 1791. First, when royalties are paid to a research account rather than paid out to the inventor, the inventor is generally not taxed as the employer is retaining the amount and allocating it toward further research, *unless* the inventor is deemed in "constructive receipt" of the payment. If the inventor may draw on the account without substantial limitations or restrictions, then the inventor will be taxed on payments made to the account. Second, if an employee-inventor later disposes of his or her research account (e.g., by sale or gift), such disposition is generally treated as the disposition of an installment obligation and is generally taxable under section 453B. In the case of a sale of RSA rights (quite uncommon), the inventor will have gain in the year of sale (equal to the difference between the inventor's basis in her RSA rights (likely zero) and the amount realized in the sale), and such gain may be eligible for section 1235 long term capital gain treatment. In the case of a gift of RSA rights, the inventor will have gain in the year of gift (equal to the difference between the inventor's basis in her RSA rights (likely zero) and the fair market value of the RSA at the time of gift, and such gain may also be eligible for section 1235 long term capital gain treatment. Note that in the case of a gift to a charity, the same result would occur, except the inventor may be entitled to an offsetting charitable contribution deduction under section 170.

**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:** Following the discussion of *Blake v. Commissioner*, add the following: In *First National Trust & Savings Bank of San Diego v. United States*, 200 F. Supp. 274 (S.D. Cal. 1961), the district court similarly concluded that section 1235 did not apply to a second transfer of bifurcated patent rights. According to the court: "The conveyance of a non-exclusive license . . . is not a transfer of a capital asset; nor, in our opinion, is a subsequent transfer of a so-called exclusive license of the same rights, but subject to the first license. That the end result of such latter conveyance may accomplish a divestiture of all substantial rights which the transferor had in the patent at the time, is not the proper criterion." In sum, for section 1235 to apply, there must be a transfer of all substantial rights to the patent and not only those rights held by the transferor immediately prior to the conveyance.

**Page 185:** For a 2017 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, aff'd No. 17-1084 (3d Cir. Mar. 26, 2018) (holding royalties received were not subject to capital gains treatment under section 1235). *Spireas* highlights the importance of timing of transfers and the language used in transfer agreements.

It should be cautioned that if a patent holder effectively controls the transferee corporation, then there is a risk that there has not been a transfer of all substantial rights. As noted later, the Ninth Circuit recently found that although the taxpayer complied with all the formal requirements of section 1235, he effectively controlled the transferee such that, in effect, there had not been a transfer of all substantial rights to the patents.

**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'"), aff'd No. 15-70863 (9th Cir. Dec. 15, 2017). If a patent holder, through effective control of the corporation, retains the right to retrieve ownership of the patent at will, then there has not been a transfer of all substantial rights. The court found that the taxpayer complied with all the formal requirements of section 1235; however, the taxpayer effectively controlled the transferee such that, in effect, there had not been a transfer of all substantial rights to the patents.

**Page 188:** In *Green Team v. Commissioner*, T.C. Memo 2017-122, the Tax Court held that the transfer of a non-capital asset (contract treated as franchise) is treated as the sale or exchange of a capital asset under section 1253(a) merely because the transferor did not retain any significant power, right, or continuing interest in the asset. In an Action on Decision (AOD), the IRS did not acquiesce in the Tax Court's holding. AOD 2019-03, 2019-42 I.R.B. 934. In the AOD, the IRS asserts that the plain language of section 1253(a) only provides that "transfers over which a taxpayer retains some power, rights, and interests are not eligible for capital gains treatment; it does not state under what circumstances gain from the transfer of a franchise is eligible for capital gains treatment." We will likely see more litigation on this issue. For commentary, see Jasper L. Cummings, Jr., *Selling Contracts for Capital Gains*, TAX NOTES FEDERAL, at 2299 (June 29, 2020) (arguing that the Tax Court relied on a questionable shortcut to find that capital gains always result from the sale of a section 1253 franchise, without considering section 1231).

**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 188-190:** It should be noted that if a taxpayer later disposes of his or her payment rights, such disposition is generally taxable under section 453B. In the case of a *sale* of payment rights, the taxpayer will have gain in the year of sale (equal to the difference between the taxpayer's basis in her rights (likely zero) and the amount realized in the sale). In the case of a *gift* of payment rights, the taxpayer will have gain in the year of gift (equal to the difference between the taxpayer's basis in her rights (likely zero) and the fair market value of the rights at the time of gift). Note that in the case of a gift to a charity, the same result would occur, except the inventor may be entitled to an offsetting charitable contribution deduction under section 170.

**Page 190**: For sole proprietors and pass-through entities engaged in licensing, royalty income may be eligible for a new deduction created by the TCJA. New section 199A provides for a deduction equal to 20% of a taxpayer's "qualified business income." The deduction, which is temporary for tax years 2018 through 2025, applies to certain sole proprietors engaged in eligible trades or businesses. Because it is immensely complicated, and because it also applies to owners in many pass-through businesses (e.g., partnerships, LLCs, or S corporations), we defer treatment of the provision to Chapters 8 and 9, which deal specifically with entity taxation. For present purposes, the effect of this deduction is to reduce the effective tax rate on business income of sole proprietorships and pass-through entities in order to level the playing field with C corporations, which are subject to a low 21% tax rate.

**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 229:** It should be noted that if an individual's attorney's fees in intellectual property suits are deductible under either section 162 or section 212 (as set forth in this chapter), they are considered "above the line" deductions (i.e., are taken into account in computing adjusted gross income). IRC § 62(a)(1), (4). This is a good thing as "below the line" deductions are subject to various tax limitations. More specifically, below the line deductions are also known as "itemized deductions. IRC § 63(b) & (d). And, some itemized deductions are labeled as "miscellaneous itemized" deductions, which means they cannot be claimed by an individual for tax years 2018 through 2025.

**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 affiliate 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 were 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 ANDA 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 8
## Taxation of Intellectual Property Held by Corporations

**Page 275:** For tax years beginning in 2018, the corporate income tax imposed by section 11(a) is a flat 21% of taxable income, which is significantly lower than the highest individual marginal rates. IRC § 11(b). Prior to 2018, a graduated corporate tax rate structure, with a top rate of 35%, existed. The Tax Cuts and Jobs Act (TCJA) eliminated the graduated rate structure and enacted a 21% flat rate to spur economic growth and jobs creation, and to make U.S. companies globally competitive. It should be noted that in addition to the federal income tax, a C corporation might also be subject to certain penalty taxes, such as the personal holding company tax. The TCJA, however, repealed the corporate alternative minimum tax.

**Page 276:** The TCJA changed the dividends received deduction when it lowered the corporate income tax rate. *See* IRC § 243(a), (c) (providing a 50%, 65%, or 100% dividends received deduction depending on how much stock is held in the subsidiary/distributee corporation).

**Page 276:** When Congress lowered the tax rate applicable to C corporations from 35% to 21%, it was concerned about the negative impact on closely held businesses that operate as pass-through entities, such as S corporations. Although not taxed at the entity level, pass-through income is automatically taxed to the individual owner at a potential top rate of 37%, which is significantly higher than the 21% flat rate applicable to C corporations. To level the playing field between C corporations and pass-through entities, Congress enacted section 199A of the Code, a temporary provision that applies to tax years beginning before 2026. It allows an individual to deduct 20% of his or her share of so-called "qualified business income" of a pass-through business entity. For top bracket individuals who qualify for this deduction, their share of pass-through income is effectively taxed at 29.6% instead of 37% (.37 x .80).

The 20% deduction can be taken only by non-corporate owners of certain sole proprietorships, partnerships, LLCs, and S corporations through 2025. C corporations and their shareholders do not qualify. The deduction is not an above the line deduction in arriving at adjusted gross income. Further, it is not an itemized deduction, but it is available to itemizers and non-itemizers alike. IRC § 63(b)(3), (d)(3).

The 20% deduction applies only to "qualified business income," which generally is the net amount of qualified items of income, gain, deduction, and loss with respect to a U.S. trade or business. IRC § 199A(c). It does not apply to investment income. IRC § 199(c)(3)(B). And, it does not apply to compensation for services rendered. IRC § 199A(c)(4). Thus, if a shareholder-employee of an S corporation received from the corporation $50,000 in salary, a $3,000 allocable share of the company's investment income (capital gain and interest income), and a $25,000 allocable share of the company's net operating income, only $25,000 would *potentially* be eligible for the 20% deduction. We say "potentially" because availability of the deduction depends upon a number of factors, including the taxpayer's income level and the type of business conducted.

There are a number of rules and limitations, the application of which depends upon whether a taxpayer falls below certain taxable income thresholds—$157,500 (for single taxpayers) or $315,000 (for married couples filing jointly). These thresholds, which are determined without regard to the section 199A deduction, are indexed for inflation after 2018. As you will see below, when taxable income exceeds these thresholds, calculation of the deduction becomes more complicated.

*Taxable Income of $157,500 or Less ($315,000 for Married Taxpayers).* For taxpayers with taxable income of not more than $157,500 ($315,000 for married couples), the deduction is 20% of qualified business income of any trade or business *other than a trade or business of providing services as an employee*. IRC § 199A(d)(1).This means that individuals working as employees are not eligible for the deduction. In the case of partnerships, LLCs, and S corporations, the deduction applies at the individual owner level and each partner or shareholder takes into account only her allocable share of the entity's net operating income. The deduction may not exceed 20% of the taxpayer's taxable income (determined without regard to the section 199A deduction) reduced by net capital gain (that is, taxable income made up of ordinary income and dividend income). IRC § 199A(a)(1)(B), (e)(1).

*Taxable Income Greater Than $157,500 ($315,000 for Married Taxpayers).* For taxpayers with taxable income exceeding $157,500 ($315,000 for married couples), things get complicated as two independent limitations begin to phase in as income increases. The first is a limitation on the types of businesses that will qualify for the deduction. The second is a cap on the amount that can be deducted, determined either by reference to a percentage of W-2 wages paid by the business or by reference to a percentage of W-2 wages and the cost of depreciable property used in business. These limitations are fully phased in when a taxpayer's taxable income reaches $207,500 ($415,000 for married couples), indexed for inflation after 2018. Within the phase-in range, only a percentage of business income gets the deduction. To simplify things , we will discuss the two limitations as if they were fully-phased in.

Under the first limitation applicable to high income earners, certain businesses ("specified service trades or businesses") are excluded from the deduction. IRC § 199(d)(1)(A), (3). These include: (1) any business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; (2) any business the principal asset of which is the reputation or skill of one or more of its employees or owners; and (3) any business involving the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. IRC § 199(d)(2). This first limitation serves to prevent high income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the deduction. Businesses not mentioned above are not excluded if they otherwise qualify. Keep in mind, however, there is an independent wage-and-capital-based limitation that may still apply to such businesses.

Under the second limitation, high income taxpayers are subject to a cap on the amount that can be deducted. The cap is the *greater of*: (1) 50% of the W-2 wages paid by the business; or (2) 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of all "qualified property." IRC § 199A(b)(2)(B). Qualified property means depreciable tangible property that is used in a qualified business to produce qualified business income, and that is still within its depreciable period (a period that ends on the later of the date 10 years after placed in service or the last day of the applicable recovery period that would apply under section 168). *Land and intellectual property assets are not qualified property*. IRC § 199A(b)(6). (For partnerships and S corporations, these caps apply at the individual partner or shareholder level. The deduction cap applicable to an S corporation shareholder, for example, will be determined by reference to the shareholder's allocable share of the corporation's W-2 wages and unadjusted basis of qualified property.) IRC § 199A(f)(1)(A)(ii).

The W-2 wage limitation is designed to apply to labor-intensive businesses, whereas the capital-based limitation is designed to apply to capital-intensive businesses. As you can see, the 20% deduction is not significant for service businesses or those that invest little in depreciable tangible property.

Even if a high income taxpayer can get past these alternative limitations, there is the overriding limitation based on taxable income. As with low income taxpayers, the section 199A deduction cannot exceed 20% of the excess, if any, of the taxpayer's taxable income over any net capital gain. IRC § 199A(a)(1)(B), (e)(1).

This new 20% deduction for qualified business income will be significant for some intellectual property owners. Indeed, there are some strategies that may be used to take advantage of the deduction. *See* Avi-Yonah et al., "The Games They Will Play: An Update on the Conference Committee Tax Bill" (Dec. 18, 2017), at 8, available at https://ssrn.com/abstract=3089423. For example, the deduction is not allowed to anyone who is an employee. As a result, someone who is creating intellectual property for an employer could quit her job and become an independent contractor or become a partner in a firm. As further example, someone in the performing arts might be able to get the deduction by spinning of his or her "brand" into a separate firm (a firm that would not provide services but would instead manage the brand and therefore avoid the restrictions on professions). More specifically, someone in the performing arts (a listed profession) could assign the right to actively license his or her image and name to a pass-through entity; it would be the pass-through entity's intellectual property (i.e., the right to license the image), and not the reputation of the owner, that would be its principal asset.

It will be interesting to see whether these strategies, if attempted, will ultimately succeed under the new law. A big issue will be how the government interprets and applies the excluded list of specified service trades or businesses. Hopefully the rules will emphasize the direct provision of services rather than the application of capital or of institutional intellectual property. *See* Marie Sapirie, *News Analysis: Making the Passthrough Deduction Work*, available at TAX NOTES, Apr. 16, 2018, at 270. *See also* Daniel L. Mellor, *Gauging the Height of the Specified Service Business Gaurdrail*, available at TAX NOTES, Feb. 5, 2018, at 809.

**Page 280:** Under the personal holding company provisions, a 20 percent penalty tax is imposed upon the "undistributed personal holding company income" of every "personal holding company."

**Page 281:** A final loss limitation rule for S corporation shareholders is found in section 461(l), which disallows any "excess business loss" of a taxpayer. IRC § 461(l)(1)(B). An excess business loss exists when a taxpayer's aggregate deductions from all trades or businesses exceed the taxpayer's aggregate gross income from such trades or businesses by more than $250,000 ($500,000 in the case of joint returns), adjusted annually for inflation. IRC § 461(l)(3)(A). Any excess business loss that is disallowed is treated as a net operating loss (NOL) carryover to the following tax year under section 172. IRC § 461(l)(2). Although NOLs may be carried forward indefinitely, an NOL may only reduce 80% of taxable income in a carryforward tax year. IRC § 172(a). For S corporations, the limit is applied at the shareholder level. IRC § 461(l)(4). Each shareholder takes into account her allocable share of income and deductions of the S corporation, and adds these to any other trade or business income and deductions she might have in determining her excess business loss. IRC § 461(l)(4)(B). Taxpayers must apply the passive activity loss rules of section 469, mentioned above, before applying the rules for excess business losses. IRC § 461(l)(6). [Note that the Coronavirus Aid, Relief, and Economic Security (CARES) Act changed some of these rules just for tax years beginning in 2018, 2019, and 2020.]

**Page 282:** The penalty tax on passive investment income is now 21% of the corporation's excess net passive income.

**Page 283-284**: Bonus depreciation of certain purchased tangible personal property plus section 197 amortization of certain purchased intellectual property over fifteen years are some reasons to buy assets as opposed to stock (although a section 338 election, discussed below, can lead to similar results). *See* Jasper L. Cummings, Jr., *Domestic Corporate M&A Toolkit*, TAX NOTES FEDERAL, at 1513 (June 1, 2020).

**Page 285-286:** Note that a selling shareholder may qualify for a 100% exclusion if the stock is section 1202 "qualified small business stock." IRC § 1202. There are eleven professional service type businesses that do not qualify for section 1202 status. *See* Priv. Ltr. Rul. 201717010 (ruling a testing lab in the healthcare field was eligible).

## Chapter 9
## Taxation of Intellectual Property Held by Partnerships

**Pages 313-314**: As noted above (Chapter 8) in connection with S corporation income, partnership income may qualify for the 20% deduction applicable to "qualified business income" (QBI). If a partner or LLC member qualifies, he or she can deduct 20% of the QBI generated by the partnership or LLC. The deduction effectively lowers the tax rate applicable to this type of pass-through income. If a partner is in the 37% rate bracket, then QBI is taxed at 29.6% (.37 x .80). If a partner is in the 35% bracket, then QBI is taxed at only 28% (.35 x .80).

As also noted above in connection with S corporation losses, section 461(l) disallows any "excess business loss" of a taxpayer. An excess business loss exists when a taxpayer's aggregate deductions from all trades or businesses exceed the taxpayer's aggregate gross income from such trades or businesses by more than $250,000 ($500,000 in the case of joint returns), adjusted annually for inflation. Any excess business loss that is disallowed is treated as a net operating loss (NOL) carryover to the following tax year under section 172. Although NOLs may be carried forward indefinitely, an NOL may only reduce 80% of taxable income in a carryforward tax year. For partnerships, the limit is applied at the partner level. Each partner takes into account her allocable share of income and deductions of the partnership, and adds these to any other trade or business income and deductions she might have in determining her excess business loss.

**Pages 321-322:** In a recent private letter ruling, the Service held that capital gains treatment under section 1235 was permitted when a patent that three individuals transferred to a limited liability company was sold. Priv. Ltr. Rul. 201710009 (Dec. 8, 2016).

**Page 324:** There are many non-tax reasons for using entities for business planning purposes, limited liability being chief among them. The choice of entity in any particular case is likely to be driven by both tax and non-tax considerations. Historically, most advisers steered their clients away from the C corporation in a closely held situation because of the potential adverse tax consequences. Recall that income of a C corporation is subject to "double taxation." Income is taxed first at the corporate level and then again when corporate dividend payments are made. Many advisors, however, are reconsidering the use of C corporations after Congress drastically reduced the corporate tax rate to

21%. However, the impact of the section 199A 20% deduction on qualified business income of pass-through entities must also be assessed. For clients who qualify for the deduction, a pass-through entity may still be the preferred choice. Whether to choose an S corporation or a partnership or an LLC requires consideration of many other factors.

## Chapter 10
## Taxation of Intellectual Property Held by Non-Profit Organizations

**Page 342:** Charities are sometimes subject to taxation. For example, "applicable tax-exempt organizations" (those exempt from taxation under section 501(a), such as those described in section 501(c)(3)) are subject to a new excise tax on excessive compensation paid to some employees; more specifically, section 4960, added by the Tax Cuts and Jobs Act of 2017 (TCJA), imposes an excise tax on the tax-exempt employers of specific employees who are paid compensation in excess of $1 million.

More importantly, profits from unrelated business activities may be subject to the unrelated business income tax (UBIT).

**Page 342:** Priv. Ltr. Rul. 201801013 (Oct. 26, 2017) (denying tax-exempt status to an organization established to fund the arts after the finding that the organization benefits private interests more than insubstantially and benefits a related for-profit company); 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. Lr. Rul. 201814010 (Jan 12, 2018) (denying an organization's application for tax-exempt status because its development and support of software for physicians served private rather than public purposes); Priv. Ltr. Rul. 201808019 (Oct. 19, 2017) (denying tax-exempt status to a corporation formed to develop open-source technology to assist people with hand amputations because the applicant was not operated exclusively for exempt purposes); 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 343-344:** Under the TCJA, section 512(a)(6) directs exempt organizations to calculate their UBIT separately for each business activity, but the provision does not say what constitutes a separate trade or business (and section 512(a)(7) uses UBIT tax liability to tax expenses for employee fringe benefits). Thus, under section 512(a)(6), losses from a business activity not related to an organization's exempt purpose can no longer offset gains from another unrelated activity.

**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 "thift 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).

**Page 345:** A taxpayer may contribute income rights (royalty sharing agreement rights) to a charity. For example, an inventor may assign his patent to a third party in exchange for payments equal to a percentage of the assignee's future licensing revenue. Then the inventor may make a charitable gift of the income rights to a charity. As noted in Chapter 6, such a gift may trigger gain recognition for the donor under section 453B (i.e., the donor would be required to include the fair market value of the royalty rights in income). The question relevant here is whether the donor can get an offsetting charitable contribution deduction under section 170. The answer should be "yes," assuming all the other requirements for deduction are met as discussed in the chapter (e.g., limitations, reductions, and documentation requirements may apply). The donor would not be deemed to contribute a "patent," but instead would be deemed to contribute property in the form of an obligation. *See* Benjamin B. Davidson, Brittany G. Cvetanovich & A.L. Spitzer, *"Just Put It in My Research Account": Transfers of RSA Rights*, available at TAX NOTES, Dec. 18, 2017, at 1791.

## Chapter 11
## Use of Domestic Intellectual Property Holding Companies

**Page 377:** As noted in the main text, if the IP holding company makes loans to the parent company, the parent company receives enjoys a tax deduction for interest paid to the IP holding company. The Tax Cuts and Jobs Act limited the deduction of business interest. IRC § 163(j).

**Page 378:** Following the cite to *Lanco,* add: *See* Kinko's Network, Inc. v. Director, Div. of Taxation, 2014 WL 448445 *3 (N.J. Jan. 31, 2014), *aff'd*, 2015 WL 4557753 (N.J. App. Ct. July 30, 2015) (Kinko's Ventures, having no physical presence in New Jersey, licensed its trademarks to Kinko's Network, which paid $70,656,890 in royalty payments for its New Jersey sales to Kinko's Ventures; followed the development in the *Lanco* decision and paid $162,437 in corporate business tax (CBT) for the 2002 sales in New Jersey to the tax authority).

**Page 378:** The *Geoffrey* case discussed in the main text was a state income tax case. Geoffrey (a subsidiary of Toys R Us) licensed intellectual property to its parent company who had a presence in South Carolina. Although Geoffrey did not have physical presence in South Carolina, the South Carolina Supreme Court found that the licensing of intellectual property into South Carolina was sufficient to create nexus with South Carolina. Geoffrey asked the U.S. Supreme Court to take up the issue, but the Supreme Court declined.

Fast forward, in 2018, the U.S. Supreme Court decided *South Dakota v. Wayfair, Inc*., 138 S. Ct. 2080. The Court overturned its prior decision in *Quill* and decided that physical presence is not required to create nexus for purposes of state sales and use taxes. Specifically, states can require online retailers to collect and remit sales taxes even if the retailer lacks a physical presence in the state.

The Court in *Wayfair* addressed a state sales tax—i.e., physical presence is not required for state sales tax purposes. Does the case support economic nexus for state income tax as well? Some states have case law holding that physical presence is not required for state income tax purposes, i.e.., confirming that economic presence is enough to establish nexus for purposes of state corporate income taxes. The U.S. Supreme Court, however, has not heard any of these state income tax cases. In light of the *Wayfair* decision, it seems unlikely that the Supreme Court will take up the decision of economic nexus for income tax purposes. Nevertheless, some commenters have suggested that *Wayfair* opens the door for decisions affirming that substantial nexus can be found for state income tax purposes if a taxpayer has economic presence within the taxing state. *See* Katherine Loughead, State Tax Changes as of January 1, 2020, Tax Foundation (Dec. 20, 2019), available at https://taxfoundation.org/2020-state-tax-changes-january-1/.

**Page 380:** In BMC Software, Inc. v. Director, Division of Taxation*,* 30 N.J. Tax 92 (May 24, 2017), the state tax court considered whether payments under a software transaction were subject to the state's addback statute (N.J.S.A. 54:10A–4.4(b)) and whether they fell into one of the exceptions to addback.

The Supreme Court of Virginia in Kohl's Dept. Stores, Inc. v. Virginia Dept. of Taxation, 810 S.E.2d 891 (Virginia 2018), handed a favorable decision to the taxpayer on Virginia's add-back statute. The Court held that the add-back statute's subject-to-tax exception applies only to the extent that the royalties were actually taxed by another state. Further, statute does not require that the related member (the out of state IP Holding Company) be the entity that pay the tax on the royalty income

**Page 380-381:** According to the Center on Budget and Policy Priorities, twenty-eight states plus the District of Columbia require combined reporting for the state corporate income tax. *See* https://www.cbpp.org/27-states-plus-dc-require-combined-reporting-for-the-state-corporate-income-tax. The trend is prevalent, with significant proposals being considered in Maryland, Pennsylvania, Florida, and Virginia. *See* State Tax Trends Emerging in 2020 State Legislative Sessions (Mar. 12, 2020), available at https://taxnews.ey.com/news/2020-0542-state-tax-trends-emerging-in-the-2020-state-legislative-sessions. Some states that already have combined reporting are expanding their statutes to encompass worldwide combined reporting.

For a recent Indiana case on whether a taxpayer was required to file a combined report with its affiliate, see Rent-A-Center East, Inc. v. Indiana Dep't of State Revenue, 432 N.E. 3d 1043 (Ind. Tax Ct. 2005). For a 2017 New York case on whether a taxpayer was required to file a combined report with its subsidiary, see 2017 WL 6272561 (N.Y. Tax App. Trib. Sept. 11, 2017).

**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.

**Page 381:** For other cases, see In the matter of the petition of Whole Foods Market Group, Inc., Determination DTA, No. 826409 (N.Y. Div. Tax App. July 14, 2016) (sustaining the notice of deficiency against Whole Foods since the taxpayer and limited partnership Whole Foods Market IP (WFMIP) were related and engaged in a unitary business that should be required to file on a combined basis, as WFMIP received more than 50 percent of its trademark royalty receipts from Whole Foods during the audit period); In the matter of the petitions of SunGard Capital Corp. and Subsidiaries, 2014 WL 1464583 (N.Y. Div. Tax App. Apr. 3, 2014) (finding the SunGard group was unitary and subject to New York State Corporation Franchise Tax Report on a combined basis).

## Chapter 12
## Overview of International Taxation

**Page 421:** As explained later, the Tax Cuts and Jobs Act of 2017 (TCJA) adopted a 100% deduction for dividends received from foreign subsidiary corporations. This change moves the United States from a "worldwide tax system" closer to a "territorial tax system" for earnings of foreign subsidiaries that are not so-called "subpart F income."

**Page 421:** Until recently, the United States had the highest corporate income tax rate among Organization for Economic Cooperation and Development (OECD) nations. The

TCJA recently lowered the corporate rate from 35% to 21%. 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.

> **Page 423:** In Coca-Cola Co. v. Commissioner, 149 T.C. No. 21, the Tax Court held that Coca-Cola was entitled to claim foreign tax credits for taxes paid to Mexico by a Mexican licensee, finding that the taxes were compulsory levies and creditable under section 901.

> **Page 423:** In The Tax Cuts and Jobs Act of 2017 (TCJA), several foreign tax credit provisions were changed. For example, TCJA added two separate limitation categories for foreign branch income and amounts includible under the Global Intangible Low-Taxed Income (GILTI) provisions, discussed below. The TCJA also changed how taxable income is calculated for purposes of the foreign tax credit limitation. The Treasury and the IRS have issued final regulations on the foreign tax credit to implement changes made by the TCJA and address other foreign tax credit issues. T.D. 9882, 84 F.R. 69022-69123.

**Page 429:** Regarding the allocation of research and development expenditures, new final regulations were released in 2020. T.D. 9922; 85 F.R. 71998-72075. The 2020 regulations eliminate the mandatory allocation of research and development expenses to a country for which the research is undertaken solely to comply with regulatory requirements. The 2020 regulations also eliminate the gross income method. The 2020 regulations retain the sales method (renamed the gross receipts method). Treas. Reg. § 1.861-7(d). The 2020 regulations have received much attention. *Compare* Stephen E. Shay, et al., *Why R&D Should Be Allocated To Subpart F and GILTI,* TAX NOTES (posted June 19, 2020), with Paul w. Oosterhuis & Moshe Spinowitz, *Why Treasury Got It Right: R&D Should Not Be Allocated to GILTI*, TAX NOTES FEDERAL, at 2041 (Sept. 14, 2020). The regulations do not allocate deductions for research and development expenditures (under section 174) to foreign source gross income inclusions under section 951 ("subpart F inclusion) or section 951A (global intangible low-tax income, or GILTI) from a controlled foreign corporation for the purpose of the foreign tax credit limitation. Some commentators have criticized the regulations, arguing that research and development expenses should be allocated to subpart F income and GILTI. But the government continues to defend its position that research and development expenses should not be allocated to subpart F income or GILTI. The preamble to the regulations contain two justifications for not allocating research deductions to subpart F inclusions or GILTI: (1) that "successful R&E expenditures ultimately result in the creation of intangible property that will be used to generate income" sufficient to cover the costs of successful and unsuccessful research, and (2) that such intangible property is fully compensated under section 482 principles without reference to foreign subsidiary earnings included under subpart F and GILTI.

## Chapter 13
## Use of Foreign Intellectual Property Holding Subsidiaries

**Page 456-457:** Historically, several features of the U.S. tax system permitted U.S. multinational companies to reduce taxes on their worldwide income:

(1) U.S. companies are generally subject to federal income tax on their *worldwide income* simply because they were organized in the United States; foreign companies, in contrast, are taxed only on *U.S. source income*, not worldwide income;

(2) Until recently, the corporate income tax rate in the United State was 35 percent, much higher than the relative tax rate in most other countries; and

(3) Until recently, U.S. shareholders of foreign corporations were subject to U.S. tax only if and when they received a distribution from the corporation or sold the stock.

These three features of the U.S. tax code opened the door to international tax planning strategies. Specifically, a U.S. company that conducts foreign business operations could lower its effective tax on worldwide income by moving its intellectual property assets and operations to a subsidiary company located in a low-tax (or no-tax) foreign country. Any foreign income earned by the foreign subsidiary would be subject to foreign tax at a low rate, but would not be subject to current U.S. taxation. Consequently, U.S. tax on the foreign subsidiary's income could be purposefully avoided (or deferred) by keeping that income overseas instead of having it distributed to the U.S. parent company in the form of a dividend. There is nothing illegal about this international tax planning strategy. Indeed, it has been used by many U.S. multinational entities principally to achieve two goals: (1) avoid current U.S. taxation on offshore profits; and (2) subject those offshore profits to as low a foreign tax as possible.

> **Example.** USCo, a U.S. pharmaceutical company, developed and obtained U.S. and foreign patents covering a new pharmaceutical drug. USCo earns $10 million of profits from sales of the drug in the United States and $10 million of profits from sales of the drug in Europe. To lower its U.S. tax burden on European sales, USCo transfers non-U.S. rights in the drug to its wholly owned subsidiary in Ireland (Ireland Co) to produce and sell the drug in Europe. The European profits will be taxed to Ireland Co at Ireland's 12.5 percent tax rate instead of being taxed to USCo at U.S.'s tax rate (21% currently, but 35% before 2018), for a significant tax savings. As long as those foreign profits stayed in Ireland, they would escape U.S. taxation.

The mobility and intangibility of intellectual property make it relatively easy for multinationals with huge portfolios of intellectual property to shift intellectual property assets and the profits they generate to tax-favored jurisdictions. There are several ways a U.S. company can transfer its intellectual property to an offshore subsidiary. A U.S. parent may make an outright *sale* of all substantial rights in the intellectual property to its controlled foreign subsidiary. Alternatively, the U.S. parent may *license* the intellectual property its foreign subsidiary. In each transaction (sale or license), there is an incentive for the foreign subsidiary to pay an artificially low price for the intellectual property. Setting license royalties as low as possible will maximize the amount of the foreign subsidiary's profits taxed at the low foreign tax rate and maximize the amount of U.S. tax deferral, assuming those profits will not be distributed to the U.S. parent. A U.S. parent may also transfer intellectual property to its foreign subsidiary *in exchange* for stock in the foreign subsidiary. In contrast to the sale and license options, no royalties *actually* flow from the foreign subsidiary to the U.S. parent.

U.S. attention to intellectual property income shifting has been growing—and, for good reasons. There is plenty of evidence that the practice has resulted in a significant erosion of the U.S. tax base. Various studies show that income shifting from the United States to low-tax jurisdictions drains more than $100 billion in corporate revenue from the United States every year. In 2016, it was estimated that U.S. multinationals had accumulated nearly $2.6 trillion in earnings of foreign subsidiaries held offshore.

Over the years, the U.S. government has attempt to respond to intellectual property income shifting by enacting various anti-deferral mechanisms. Many of these mechanisms target highly mobile income from easily moveable intellectual property of domestic multinational companies. Indeed, most barriers have been aimed at multinational companies that perform research and development domestically, but then shift ownership (and related functions) of developed intellectual property to low-tax or no-tax foreign countries where profitable operations occur, and then engaged in advantageous transfer pricing practices. In Chapter 13, we explore some anti-deferral regimes applicable to U.S. companies that use foreign corporations to avoid or defer U.S. tax (e.g., the controlled foreign corporation rules of Subpart F of the Internal Revenue Code and the transfer pricing rules under section 482). The problem with these anti-deferral regimes is that they have been quite ineffective at eliminating deferral of taxation on a subsidiary's foreign income. Below, we describe why these measures have been ineffective.

Due to the fact that previous efforts have been ineffective at curtailing the use of aggressive tax minimization strategies by multinationals, the Tax Cuts and Jobs Act (TCJA) made several fundamental changes to the taxation of multinational companies.
To encourage U.S. companies not to lodge their foreign earnings outside the United States, the TCJA adopted a 100% deduction for dividends received from foreign subsidiary corporations. IRC § 245A (providing a dividends received deduction for the foreign-source portion of dividends received from a foreign subsidiary). This change moves the United States from a "worldwide tax system" closer to a "territorial tax system" for earnings of foreign subsidiaries that are not subpart F income. (It also created a special deduction for certain foreign-derived intangible income, a welcome incentive for companies to locate intangible property in the United States. IRC § 250 This new provision in effect grants the benefit of a reduced tax rate to a new class of income earned directly by a U.S. corporation (foreign derived intangible income)).

In addition to the above *carrot* measures, however, the TCJA adopted a number of *stick* measures to limit aggressive tax minimization strategies. It adopted a minimum tax on "global intangible low-taxed income" (GILTI). IRC § 951A. Thus, in addition to retaining current subpart F of the Code (which immediately taxes certain classes of income), the TCJA subjects a new, very broad, class of income (GILTI) to immediate taxation at a reduced rate. The TCJA also adopted a "Base Erosion Anti-Abuse Tax" (BEAT), an anti-base erosion measure that imposes a minimum tax on certain deductible payments, such as royalties, to a foreign affiliate. IRC § 59A. These and other recent tax law changes impacting multinationals are summarized below.

**Page 457:** If a foreign corporation is a "controlled foreign corporation" at any time during the tax year, each "U.S. shareholder" must include in his or her gross income the shareholder's pro rata share of the corporation's "subpart F income." A "U.S. shareholder" for controlled foreign corporation purposes is any U.S. person who owns 10 percent or more of the foreign corporation's stock. IRC § 951(b), as amended by the TCJA (expanding the definition of U.S. shareholder).

**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 come 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).

In the TCJA, the definition of intangible property was modified to include goodwill, going concern value, and workforce in place as well as any other item the value of which is not attributable to tangible property or services of any individual. IRC § 936(h)(3)(B). In addition, the Treasury has the authority to specify the method to be used to determine the value of intangible property in the context of both section 367(d) (transfers as part of outbound restructurings of U.S. operations) and section 482 (inter-company pricing allocations). IRC § 367(d)(2)(D).

[NOTE: The IRS has discretion under the regulations to exclude the section 367(d) deemed royalty from the parent company's income. Treas. Reg. § 1.1502-13(c)(6)(ii)(D). In a recent Private Letter Ruling, the IRS exercised such discretion in connection with intellectual property moved from a foreign subsidiary to the domestic parent's consolidated group in a series of transactions. Priv. Ltr. Rul. 201936004 (June 4, 2019). Apparently, the IRS is concerned that the rules for outbound intangible transfers (such as section 367(d)) could negatively interfere with the TCJA's goals of attracting or retaining intellectual property.]

**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. 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 county with a treaty with Ireland.

**Page 462-465:** 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.

*The Tax Cuts and Jobs Act of 2017 (TCJA*). To encourage U.S. businesses to report and pay income taxes in the United States rather than use foreign subsidiaries to lodge their earnings outside of the United States, the TCJA recently made several tax law changes. As noted earlier, the TCJA reduced the corporate rate from 35% to 21%. In addition, the TCJA adopted a 100% deduction for dividends received from foreign subsidiary corporations. Specifically, new section 245A provides a dividends received deduction for the foreign-source portion of dividends received from a foreign subsidiary. This change moves the United States from a "worldwide tax system" closer to a "territorial tax system" for earnings of foreign subsidiaries that are not subpart F income.

Although reducing the corporate rate may reduce incentives to shift profits outside the United States, the shift to a territorial system could exacerbate those incentives because any profits shifted offshore would be permanent exempt from U.S. tax. In response, the TCJA includes additional anti-base erosion measures.

*1. Minimum Tax on Global Intangible Low-Taxed Income (GILTI)*

The TCJA adopted a minimum tax on so-called "global intangible low-taxed income" (GILTI). IRC § 951A. This subjects a new, very broad class of foreign intellectual property income (GILTI) to immediate taxation, albeit at a reduced rate. [Corporate shareholders are allowed a deduction equal to 50 percent of GILTI for 2018 through 2025, which will be decreased to 37.5% beginning in 2026. As a result, the effective tax rate on GILTI for a U.S. corporate parent is 10.5% prior to 2026, and 13.125% after 2026.

The computation of the new tax is complicated, but essentially it is imposed on the excess of a controlled foreign corporation's net income over a deemed return on the controlled foreign corporation's tangible assets (10% of depreciated tax basis). A credit is allowed for 80 percent of foreign taxes paid.

Many U.S. multinational companies will likely be subject to this new minimum tax (that is, the immediate tax will be imposed on most of the earnings of controlled foreign corporations). It will be interesting to see its ultimate impact. Indeed, some commentators are now reassessing the Double Irish structure (described in an earlier part of this chapter), and whether it continues to deliver tax savings. According to some analysists, firms will have an incentive to move tangible assets (such as R&D facilities and operations) abroad in order to reduce GILTI. Even at 10.5% (currently), the immediate tax will be unfavorable to the controlled foreign corporation regimes of many of the U.S.'s trading partners, which tax CFC earnings in much more limited circumstances).

*2. Base Erosion Anti-Abuse Tax (BEAT)*

The TCJA also adopted an anti-base erosion measure that imposes a minimum tax on certain deductible payments, such as royalties, to a foreign affiliate. IRC § 59A. The BEAT is an additional tax (almost like an alternative minimum tax) applicable to large corporations that reduce their U.S. tax liabilities below a certain threshold by making deductible payments (e.g., royalties) to related foreign entities.

The BEAT applies to corporations: (1) that are part of a group with at least $500 million of annual domestic gross receipts (determined over a three-year averaging period), and (2) that have a "base erosion percentage" of 3% or higher (determined by dividing deductions attributable to payments to related foreign persons by the total amount of the corporation's deductions for the year). If applicable, the BEAT liability applies in addition to a company's regular income tax liability. The BEAT rate is 5% for 2018, 10% for 2019-2025, and 12.5% after 2025. Computation of BEAT tax is complicated; at a very basic level, it is determined as follows: [5% (for 2018) x modified taxable income (taxable income with no deduction for royalties to related foreign entities)] – pre-credit regular tax liability (with all deductions).

The BEAT generally applies to payments paid or accrued in tax years beginning after December 31, 2017. IRC § 59A

*3. Hybrid Transactions and Hybrid Entities*

The TCJA disallows a deduction for royalties paid pursuant to a hybrid transaction, or by, or to, a hybrid entity. For example, no deduction is allowed for royalties paid or accrued to a related party if (1) there is no corresponding income inclusion to the related party under local tax law, or (2) such related party is allowed a deduction with respect to the payment under local tax law. A disqualified payment does not include any payment to the extent such payment is included in subpart F income.

*4. Other TCJA Measures*

It is not all as bad as it seems. As a complement to the new minimum tax regime discussed above on excess returns earned by a controlled foreign corporation, the TCJA provides a low effective tax rate on excess returns earned directly by a U.S. company from foreign sales (including licenses from intangibles in the United States). IRC § 250. The preferential rate on "foreign-derived intangible income" (FDII) was designed to encourage companies to locate their intangibles in the United States. This was intended to be a major carrot for U.S. multinationals. According to some analysists, however, it is not likely to encourage firms to move their intangible assets back to the United States because of the uncertainty over the validity of the regime under international trade rules.

*The OECD's Base Erosion and Profit Shifting Project*

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 some of the multilateral commitments 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).

[NOTE: Action Item #1 of the BEPS Project related to taxation of the digital economy. The action took a wait-and-see approach, however, so the OECD has recently taken on the topic again in what is referred to as BEPS 2.0. There have been significant recent developments, including the European Union's push for an aggressive approach to taxation of U.S. digital companies.]

> **Page 465:** In the Tax Cuts and Jobs Act of 2017 (TCJA), Congress enacted a participation regime (section 965) for a "one time" tax holiday. Under section 965, U.S. parents of foreign controlled companies could claim an 85 percent deduction

for dividends received. This was known as a one-time transition tax or toll charge on deferred foreign earnings and profits of controlled foreign corporations

**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 476:** Transfer pricing is something multinational deal with a lot. In a recent survey, 72 percent of corporate respondents identified transfer pricing as the most important international tax issue they face. *See* EY, "2016 Transfer Pricing Survey Series: A New Era of Transparency and Risk," available at http://www.ey.com/Publication/vwLUAssets/EY-a-new-era-of-transparency-and-risk-ie/$FILE/EY-a-new-era-of-transparency-and-risk-ie.pdf. With the rise in the digital economy, cloud computing (the provision of information technology resources remotely through the Internet) presents additional tax challenges for taxpayers and governments. *See* Orly Mazur, *Taxing the Cloud: Transfer Pricing Considerations*, TAX NOTES TODAY, Feb. 15, 2017, 2017 TNT 30-9.

**Page 477:** <u>The government lost every major transfer pricing case it litigated between 1979 and 1994</u>. Examples includes cases against U.S. Steel Corp., Bausch & Lomb Inc., HCA Healthcare, Eli Lilly and Co., G.D. Searle LLC, Ciba-Geigy AG, Sundstrand Corp., and Merck & Co. Inc.*See* Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, University of Michigan, Law & Economics Olin Working Paper No. 07-017 and Public Law Working Paper No. 92 (Sept. 27, 2007), cited in Reuven S. Avi Yona & Gianluca Mazzoni, *Coca Cola: A Decide IRS Transfer Pricing Victory, at Last*, TAX NOTES FEDERAL, at 1739 (Dec. 14, 2020).

<u>After new transfer pricing regulations were issued in 1994, there was a pause in transfer pricing litigation. When cases resumed in the late 1990s, the IRS continued losing</u>. Examples include cases against DHL Corp. (1998), UPS 91999), Compaq (1999), Xilinx Inc. (2005), Veritas Software Corp. (2009), Medtronic Inc. (Tax Court 2016), and Amazon.com Inc. (2017). Reuven S. Avi Yona & Gianluca Mazzoni, *Coca Cola: A Decide IRS Transfer Pricing Victory, at Last*, TAX NOTES FEDERAL, at 1739 (Dec. 14, 2020).

<u>In recent years, however, "there have been signs that the IRS litigation effort is improving."</u> In 2018, *Medtronic* (discussed below) was reversed on appeal and remanded to the Tax Court. In 2019, *Altera* (discussed below) was reversed on appeal. In 2020, the Tax Court decided *Coca Cola* (discussed below) in favor of the IRS. *Id*.

**Page 478:** The Tax Cuts and Jobs Act of 2017 (TCJA) clarified the authority of the Secretary of the Treasury to specify the method to be used to determine the value of intangible property in the context of both section 367(d) and section 482. *See* IRC § 482, as amended by the TCJA. Specifically, the Treasury will require: (1) the valuation of transfers of intangible property, including intangible property transferred with other property or services, on an aggregate basis, or (2) the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the IRS determines that such basis is the most reliable means of valuation of such transfers. *Id*.

**Page 478-479:** In Medtronics 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.

In 2018, *Medtronic* was reversed on appeal and remanded to the Tax Court. 900 F.3d 610 (8th Cir. 2018). The Eight Circuit found that the Tax Court's factual findings were insufficient to enable the court to conduct an evaluation of its determination. Specifically, the Tax Court failed to scrutinize adequately the degree of comparability between (1) the agreement offered by Medtronic as a comparable and (2) the intercompany license to its Puerto Rico manufacturing affiliate. The Circuit remanded the case to the Tax Court for reconsideration.

**Page 479:** In a more recent, decisive, victory for the IRS, the Tax Court in *Coca-Cola Co. v. Commissioner* applied the comparable profits method in applying section 482. 155 T.C. No. 10 (2020). Coca-Cola, a U.S. company, transferred its intellectual property to its foreign manufacturing (supply-point) affiliates under a certain formula (which Coca-Cola and the IRS agreed upon when settling a pre-1996 audit). For the years at issue (2007-2009), the IRS claimed that formula was not arm's length. Invoking section 482, the IRS reallocated profits to Coca-Cola using a comparable profits method (CPM)—focusing on average returns for a group of independent Coca-Cola bottlers that the IRS deemed comparable. The taxpayer challenged the allocations as arbitrary and capricious, and argued that the CPM method was inferior to other transfer pricing methods. The Tax Court rejected the argument, applying the "best method" rule based on availability of adequate data. *Id*. (citing Treas. Reg. § 1.482-5(e) (treating the CPM as the best method where the foreign manufacturing affiliate performs routine functions)). The court held that none of the other methods (which are discussed in this chapter) was the best method for the Coca-Cola case.

**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 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. [It should be noted that in another Tax Court case, SIH Partners LLLP v. Commissioner, 150 T.C. No. 3 (2018), the Tax Court upheld the validity of subpart F regulations. At least one commentator has questioned whether that recent case might blunt the impact of the high-profile *Altera* case (albeit dealing with another set of regulations). *See* Andrew Velarde, *Recent Tax Court Case May Confine Altera to Transfer Pricing*, available at Tax Notes, Mar. 12, 2018, available at https://www.-taxnotes.com/tax-notes-today/tax-system-administration/recent-tax-court-case-may-confine-altera-transfer-pricing/2018/03/12/26yw5?highlight=%22section%20482%22.]

The government appealed its loss in *Altera* to the Ninth Circuit. On appeal, the Ninth Circuit reversed the Tax Court decision (reversing the outcome it reached in *Xilinx*). 926 F.3d 1061 ($9^{th}$ Cir. 2019). The Ninth Circuit held the 2003 cost sharing regulations complied with the Administrative Procedure Act's procedural and substantive requirements. The court held they were not arbitrary or capricious, and they were not incompatible with the arm's-length standard as modified by the commensurate with income rule.

In 2020, the Supreme Court denied certiorari in *Altera*, No. 19-1009 (S. Ct. 2020), "bringing to an end for now the long and convoluted saga of the litigation over whether the cost of stock options must be included in qualified cost sharing arrangements." Reuven S. Avi-Yonah, *Letter To the Editor, The Implications of Altera*, TAX NOTES FEDERAL, at 2324 (June 29, 2020). It goes without saying, that this was a major victory for the IRS, representing "the first time it has unequivocally won a major transfer pricing case since *Dupont* in 1979." *Id*. Nevertheless, *Altera* relates to a very narrow issue. Other recent transfer pricing cases, such as *Medtronic* and *Coca-Cola*, discussed earlier, are arguably more important.

**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*. The IRS appealed to the Ninth Circuit, insisting that it chose the best way to value the buy-in payment between Amazon and its European subsidiary for the transfer of preexisting intangibles. The IRS argued that the Tax Court's analysis under the CUT method was unreasonable. The Ninth Circuit affirmed the Tax Court decision that rejected the IRS's method for determining a buy-in payment. 934 F.3d 976 (ith Cir. 2019).

NOTE: The ongoing saga regarding buy-in payments under cost sharing arrangements continues. As noted above, Amazon was involved in recent litigation. Facebook, too, is in ongoing transfer pricing litigation in which it is challenging the IRS's adjustment of a buy-in payment under a cost sharing arrangement with an Irish foreign affiliate. *See* Stephen L. Curtis, *Facebook, the IRS, and the Commensurate With Income Standard*, TAX NOTES FEDERAL, at 1863 (Dec. 21, 2020).

**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 486:** In a recent case, the Tax Court held that there were no net section 482 adjustments in a transfer pricing dispute to support the imposition of section 6662(h) penalties. Eaton Corp. v. Commissioner, 153 T.C. 119 (Oct. 28, 2019).

**Page 487:** According to an IRS report, 120 APAs were executed in 2019, compared with 107 in 2018. IRS Announcement 2020-2, 2020-15 I.R.B. 609. The median completion time for an APA in 2019 was 38.8 months; 121 applications were filed in 2019. *Id*. For guidance on requesting and obtaining APAs, see Rev. Proc. 2015-41, 2015-35 I.R.B. 263.

## Chapter 15
## Estate Planning for Intellectual Property

**Page 540-541:** *See* Andrew Gilden, IP R.I.P., 95 Wash. U.L. Rev. 639 (2017) (addressing the postmortem role that intellectual can play after an author/artist's death); Eva E. Subotnik, *Artistic Control After Death*, 92 WASH. L. REV. 253 (2017) (evaluating instructions authors give with respect to their works, considering the enforceability of attempted artistic control, and arguing that authorial instructions must yield to the needs of the living).

**Page 542:** For example, starting in 2018, an unmarried decedent's estate of less than $10,000,000 (adjusted for inflation) escapes any federal estate tax if the decedent made no lifetime taxable gifts. A married couple could easily pass more than $20,000,000 (adjusted for inflation) in property to their children free of federal estate tax. [Note: The Tax Cuts and Jobs Act of 2017 (TCJA) only increased the basic exclusion amount to $10,000,000 temporarily. The increase is scheduled to sunset on January 1, 2026, and fall back to $5,000,000. This has dramatic implications for many existing and future estate plans.]

**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 2018, an unmarried decedent's estate of less than $10,000,000 escapes any federal estate tax if the decedent made no lifetime taxable gifts.

**Page 544:** The gift-tax inflation-adjusted exclusion for 2018 was $15,000.

**Page 545:** With the $10,000,000 exemption equivalent of the unified credit (adjusted for inflation), substantial wealth can be transferred during life over and above those amounts qualifying for gift tax exclusions, at little or no tax cost.

**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 547:** The Treasury Department had issued proposed regulations under section 2704 to deal with the use of FLPs and FLLCs to obtain with valuation discounts. Prop. Treas. Reg. § 1.2704-2(b) (withdrawn). These regulations, however, were put in abeyance under Executive Order 13789, and eventually withdrawn.

**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.

**Page 548:** It should be noted that the substantially higher estate and gift tax exemption amount under the Tax Cuts and Jobs Act of 2017 (i.e., $10,000,000) may have estate planners reconsidering the role of insurance in estate tax planning. *See* Jonathan Curry, *Life Insurance's Role in Estate Tax Planning Now in Flux*, available at TAX NOTES, Apr. 5, 2018.