

**2012 Student Update Memorandum for
Maine & Nguyen's
Intellectual Property Taxation:
Problems and Materials
(2004)**

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In recent years, the Supreme Court has considered a number of intellectual property cases. For example, in *eBay, Inc. v. MercExchange*, 547 U.S. 388 (2006), the Supreme Court reversed the Federal Circuit's decision that permanent injunction should be granted as a general rule to the prevailing plaintiff in patent infringement cases. In *KSR International Co. v. Teleflex Inc.*, 550 U.S. 398 (2007), the Supreme Court rejected the Federal Circuit's "teaching-suggestion-motivation" (TSM) test as too rigid and formalistic to evaluate whether an invention is obvious or nonobvious; the Court favored an expansive and flexible approach to the question of obviousness. In *In re Bilski*, 561 U.S. ____ (2010), the Supreme Court again rejected the Federal Circuit's machine-or-transformation test for determining whether an invention is patentable subject matter under 35 U.S.C. §101. Though rejecting the Federal Circuit's "machine or transformation" test as the sole test to determine patentable subject matter for business method inventions, the Supreme Court did recognize that the test is a useful one.

On September 16, 2011, President Barack Obama signed into law the Leahy-Smith America Invents Act (AIA). This marks a sweeping change in U.S. patent law, moving the "first to invent" system into harmonization with other nations and their "first to file" system. Notably, the AIA grants priority to the first inventor to file a patent application or to the first inventor to disclose the invention to the public, if they then file the application within a year. To determine whether an invention is novel, the AIA expands prior arts. Specifically, if the claimed invention was patented, described in a printed publication, or in public use, on sale, or otherwise available to the public before the effective filing date, the claimed invention is not patentable. Prior art is no longer limited to the United States; prior art can occur worldwide. These new standards will become effective after March 16, 2013. The AIA expands existing prior user rights from the business method patents to "a process, or a machine, manufacture, or composition of matter used in a manufacturing or other commercial process." This expansion became effective after September 16, 2011. AIA's other important changes are beyond the scope of this Section.

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In 2006, Congress passed the Trademark Dilution Revision Act (TDRA). 15 U.S.C. § 1125(c). Under the TDRA, the owner of a famous trademark is entitled to an injunction against a defendant who uses a trademark or trade name that is *likely* to cause dilution by blurring or tarnishing the famous trademark. The TDRA does not require the trademark owner to prove confusion (whether actual or likely), competition, or actual economic injury. Other remedies in addition to an injunction are available to the prevailing trademark owner if the defendant's conduct was willful.

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The Ninth Circuit has held that under California law domain names are intangible property subject to conversion claims. *See* CRS Recovery, Inc. v. Laxton, 600 F.3d 1138 (9th Cir. 2010) (citing Kremen v. Cohen, 337 F.3d 1024, 1030 (9th Cir. 2003). *Compare In re Paige*, 413 B.R. 882, 918 (Bankr. D. Utah 2009) (applying Utah law, concluding that “like web pages and software, the Domain Name at issue is a type of tangible property that is capable of conversion”).

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To provide additional guidance with respect to capitalization, the Treasury has issued comprehensive regulations related to the capitalization of both tangible and intangible assets. In 2004, the Treasury issued final regulations on the capitalization of costs related to *intangible* property. Treas. Reg. § 1.263(a)-4. More recently, for tax years beginning in 2012, the Treasury issued temporary regulations on the capitalization of costs related to *tangible* property. Temp. Treas. Reg. § 1.263(a)-1T, -2T, -3T.

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Current income tax rates on ordinary income are 10%, 15%, 25%, 28%, 33%, and 35%. I.R.C. § 1(i)(1)-(2). By contrast, the current rates on net capital gain are much lower— 0%, 15%, 25%, or 28%. I.R.C. § 1(h). The applicable capital gain rate depends on several factors, including the nature of the asset producing capital gain, and the taxpayer’s ordinary income tax bracket. For example, capital gain from the sale of a “collectible” is taxed at a maximum rate of 28%. Capital gain from the sale of most other assets is taxed either at a rate of 0% (if the taxpayer’s ordinary marginal tax rate is 10% or 15%) or at a rate of 15% (if the taxpayer’s ordinary marginal tax rate is 25%, 28%, 33%, or 35%). These rates on ordinary income and capital gain are scheduled to sunset beginning after 2012. Absent action by Congress, the following rates on ordinary income will apply: 15%, 28%, 31%, 36%, and 39.6%; and the maximum tax rate on net capital gains will return to 20% (10% for taxpayers in the 15% bracket).

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In January 2004, the Service issued final regulations under § 263 that provide comprehensive rules for capitalization of amounts paid to acquire or create intangible assets. *See* T.D. 9107, 68 Fed. Reg. 436-01. The final regulations adopt with some minor revisions the proposed regulations that were issued in December 2002. The final regulations apply to amounts paid or incurred on or after December 31, 2003. Treas. Reg. § 1.263(a)-4(o).

The final regulations eliminate the use and definition of the term “intangible asset” that was contained in the proposed regulations. The final regulations simply identify categories of

“intangibles” for which amounts are required to be capitalized. 68 Fed. Reg. 436-01, 437. They are: (1) certain identified intangibles, including certain rights obtained from a governmental agency; (2) separate and distinct intangible assets; and (3) future benefits as identified in subsequent published guidance. Treas. Reg. § 1.263(a)-4(b)(1)(ii)-(iv).

The general definition of a separate and distinct intangible asset in the final regulations is unchanged from the proposed regulations (i.e., a separate and distinct intangible asset must be intrinsically capable of being sold, transferred, or pledged separate and apart from a trade or business). *Id.* § 1.263(a)-4(b)(3)(i). The application of the separate and distinct intangible asset definition to certain intangibles, however, has been limited in the final regulations. For example, an amount paid to create computer software is *not* treated as an amount that creates a separate and distinct intangible asset. *Id.* § 1.263(a)-4(b)(3)(iv). This makes sense due to the fact that the costs of creating computer software have been held to be immediately deductible when paid or incurred. *See* Rev. Proc. 2000-50, 2000-2 C.B. 601.

More interesting, the final regulations provide that an amount paid to create a package design is *not* treated as an amount that creates a separate and distinct intangible asset. Treas. Reg. § 1.263(a)-4(b)(3)(v) (“Package design” is defined as “the specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and other elements on a given product package, or the design of a container with respect to its shape or function.”) Before the final regulations were issued, the Service took the position that the costs of creating a package design had to be capitalized because package designs do not have ascertainable useful lives. *See* Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (app. § 3.01); Rev. Proc. 97-35, 1997-2 C.B. 48 (§ 5); Rev. Rul. 89-23, 1989-1 C.B. 85. The Tax Court disagreed in *RJR Nabisco, Inc. v. Commissioner*, a case excerpted in the materials. Under the final regulations, the costs of creating a package design are deductible because a package design is not a separate and distinct intangible asset. It should be noted that although a taxpayer can deduct the costs of developing a package design, the taxpayer must capitalize the costs of obtaining trademark and copyright protections on elements of the package design, since these are rights granted by a governmental agency. The final regulations provide the following example:

Z corporation manufactures and markets personal care products. Z pays \$100,000 to a consultant to develop a package design for Z’s newest product, Product A. Z also pays a fee to a government agency to obtain trademark and copyright protection on certain elements of the package design.

Treas. Reg. § 1.263(a)-4(l), Example 9(i). Z is not required to capitalize the \$100,000 payment since amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset. *Id.* § 1.263(a)-4(l), Example 9(ii). However, amounts paid by Z to the government agency to obtain trademark and copyright protection are amounts paid to a government agency for a right granted by that agency. Accordingly, Z must capitalize the payment. *Id.* § 1.263(a)-4(l), Example 9(iii).

The final regulations under § 263 retain the 12-month rule contained in the proposed regulations. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create (or facilitate the creation of) certain rights or benefits with a brief duration. Taxpayers must file I.R.S. Form 3115 to change their method of accounting from capitalization to current expensing under the 12-month rule.

As with the proposed regulations, the final regulations under § 263 require the capitalization of an amount paid to “facilitate” the taxpayer’s creation of an intangible if the amount is paid in the process of investigating or otherwise pursuing the transaction. *Id.* § 1.263(a)-4(b)(1)(v), -4(e)(1)(i). Whether an amount is paid to “facilitate” a transaction depends on all the facts and circumstances. *Id.* § 1.263(a)-4(e)(1)(i). In making the determination, the fact that the amount would (or would not) have been paid “but for” the transaction is relevant, but is not determinative. *Id.*

The final regulations clarify that investigatory costs are within the scope of the capitalization rule. *Id.* § 1.263(a)-4(e)(1)(i). The proposed regulations had provided that an amount facilitates a transaction if it is paid “in the process of pursuing the transaction.” The final regulations, in contrast, provide that an amount facilitates a transaction if it is paid “in the process of investigating or otherwise pursuing the transaction.” *Id.* The final regulations also clarify that an amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction. *Id.*

The final regulations retain the simplifying conventions applicable to employee compensation, overhead, and de minimis costs, with several modifications. *Id.* § 1.263(a)-4(e)(4)(i). Under the new final regulations, employee compensation includes certain amounts paid to persons who may not be “employees” of the taxpayer. For example, a guaranteed payment to a partner in a partnership is treated as employee compensation under the final regulations. *Id.* § 1.263(a)-4(e)(4)(ii)(B). In addition, annual compensation paid to a director of a corporation is treated as employee compensation. *Id.* The employee simplifying convention is extended to amounts paid to so-called independent contractors and outside contractors for secretarial, clerical, and similar administrative services. *Id.* As can be seen, the final regulations make virtually every payment for services deductible.

The final regulations allow taxpayers to elect to capitalize employee compensation, overhead, or de minimis costs. *Id.* § 1.263(a)-4(e)(4)(iv). A taxpayer might capitalize such costs for financial accounting purposes and prefer not to segregate such costs for federal income tax purposes. Preamble, 68 Fed. Reg. 436, 440. A capitalization election can be made with respect to any or all of the three categories of costs covered by the simplifying conventions. *Id.*

The final regulations retain the amendments to Treas. Reg. § 1.167(a)-3 as contained in the proposed regulations (i.e., providing a 15-year safe harbor amortization period for certain created intangibles that do not have readily ascertainable useful lives). *Id.* § 1.167(a)-3(b). The new safe harbor amortization period applies to intangibles created on or after December 31, 2003. *Id.* § 1.167(a)-3(b)(4).

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Section 263A requires that a taxpayer's direct costs and some indirect costs of producing certain property be capitalized (included in inventory costs if the produced property is inventory) regardless of whether incurred before, during, or after the production period. Treas. Reg. § 1.263A-2(a)(3). The "*direct costs*" of produced property include the costs of those materials that become an integral part of the asset produced and those materials that are consumed in the production process, as well as compensation paid for full-time, part-time, and contract labor. *Id.* § 1.263A-1(e)(2). The "*indirect costs*" of produced property include, for example, purchasing costs, storage costs, depreciation, rent, taxes, insurance, utilities, and maintenance. *Id.* § 1.263A-1(e)(3). Indirect costs must be capitalized to the extent they are properly allocable to produced property (i.e., when the costs directly benefit or are incurred by reason of the performance of production activities or resale activities). *Id.* [Note: If the produced property is inventory, two methods exist for allocating costs to inventory: (1) the "facts and circumstances" method; and (2) the "simplified production method." The facts and circumstances method, the most commonly used, provides various cost allocation methods that taxpayers may use to allocate direct and indirect costs to units of property produced or acquired for resale based on a relationship between the units of property produced or acquired for resale. *Id.* § 1.263A-1(f). The simplified production method uses a ratio provided in the regulations to allocate a pool of capitalizable costs between ending inventory and costs of goods sold rather than allocating specific costs to particular goods. *Id.* § 1.263A-2(b). Taxpayers wishing to switch from one method to the other must first obtain the Service's consent.]

Certain costs do not need to be capitalized. Selling and distribution costs (e.g., marketing, selling, and advertising costs) do not fall within the ambit of § 263A. *Id.* § 1.263A-1(e)(3)(iii)(A). Moreover, costs incurred in the rendition of services are not within the uniform capitalization rules of § 263A even if the rendition of services results in the production of tangible personal property. *Id.* § 1.263A-2(a)(2)(ii)(B)(2). For example, costs incurred by a photographer who takes pictures at a wedding do not fall within § 263A because production of property is incidental to the services rendered.

Tax Treatment of Sales-Based Royalties. It may be difficult to determine whether indirect costs are allocable to a production activity (capitalized) or some other activity that is not subject to § 263A (expensed). Assume that a taxpayer licenses the right to use intellectual property in the manufacture and distribution of products in exchange for royalty payments. If the taxpayer is required by the royalty agreement to make a royalty payment for each product the taxpayer manufactures, it would seem that the taxpayer should be required to capitalize the royalty payment as a production cost (relates to production activities). If, however, the taxpayer is required to make a royalty payment for each product the taxpayer sells, it would seem that the royalty payment should not be required to be capitalized but should be deducted as a selling expense (relates to sales activities). According to one commentator, the Service does not necessarily make this distinction and has employed "a one-size-fits-all approach with respect to

the tax accounting for royalty costs.” See “Firm Comments on Tax Treatment of Manufacturers’ Post-Production Royalties,” 2008 TNT 120-26 (May 9, 2008) (suggesting that the government should provide clarification on when a taxpayer “may deduct as a selling expense royalties that arise by reason of the taxpayer’s sales activities”).

The Service’s position on the deductibility of sales-based trademark royalty payments was recently tested in *Robinson Knife Manufacturing Co., Inc. v. Commissioner*, T.C. Memo 2009-9 (Jan. 14, 2009), *rev’d*, No. 09-1496 (2d Cir. Mar. 19, 2010). The taxpayer, a kitchen-tool manufacturing company, licensed the right to use well-known trademarks in connection with some of its kitchen tools it produces and sells, agreeing to pay licensors royalties based on a percentage of net sales of the tools bearing the licensors’ trademarks. The Tax Court agreed with the Service that the taxpayer must capitalize the royalties under § 263A as indirect costs (i.e., licensing costs) properly allocable to property produced. The Tax Court disagreed with the taxpayer’s argument that the royalties did not directly benefit its production activities and, thus, were not properly allocable to property produced. The Tax Court also disagreed with the taxpayer’s argument that the royalties paid were marketing expenses that are exempt from the § 263A capitalization rules.

The Tax Court’s decision was recently reversed by the Second Circuit, which ruled that the sales-based royalty payments were currently deductible because they were not properly allocable to property produced. Although the Second Circuit rejected the taxpayer’s argument that the royalty payments were deductible as marketing, selling, advertising, or distribution costs, it was persuaded by the taxpayer’s argument that the royalty payments were not “properly allocable to property produced” within the meaning of Treas. Reg. § 1.263A-1(e): “We hold that where, as here, a producer’s royalty payments (1) are calculated as a percentage of sales revenue from inventory and (2) are incurred only upon the sale of that inventory, they are immediately deductible as a matter of law because they are not ‘properly allocable to property produced’”. Some commentators suggested that taxpayer’s might consider changing their method of accounting method in light of the decision. See Carol Conjura, Matt Yokitis, & Peter Beale, *Sales-Based Royalties are Not Capitalizable Into Ending Inventory*, TAX NOTES 1013 (May 31, 2010).

After the Second Circuit’s decision in *Robinson Knife*, the Treasury Department issued proposed regulations on sales-based royalties. The proposed regulations, released in December 2010, provide a taxpayer-favorable *result* similar to that reached by the Second Circuit. Technically, the proposed regulations provide that sales-based royalties may be capitalizable to property produced by a taxpayer. Prop. Treas. Reg. § 1.263A-1(e)(3)(i). But then the proposed regulations provide a broad relief provision that such royalties required to be capitalized are allocable only to costs of goods sold (and not ending inventory). *Id.* § 1.263A-1(e)(3)(ii)(U)(2). So, although the regulations do not say that sales-based royalty costs are inherently non-capitalizable, they do provide that otherwise capitalizable sales-based royalties are properly allocable to property sold during the year. In short, the proposed regulations achieve a similar result to that in *Robinson Knife*. Most taxpayers will not have to capitalize their sales-based

royalties into ending inventory. The proposed regulations apply for tax years ending on or after the date the regulations are published as final regulations.

For a recent IRS administrative pronouncement holding that book publication costs incurred by a publisher (i.e., direct material costs, direct labor costs, and indirect costs properly allocable to its production activities) are required to be capitalized to inventory under § 263A, see IRS Legal Memorandum 200727014 (Feb. 9, 2007).

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Although § 263A(h) does not apply to expenses related to motion picture films or similar property, § 181, enacted by the American Jobs Creation Act of 2004, provides an important exception to the uniform capitalization rules for certain film and television productions. Under § 181, a taxpayer may elect to immediately deduct the cost of any “qualified” film or television production in lieu of capitalizing such cost. I.R.C. § 181(a)(1). A production is a “qualified” production if: (1) 75 percent of the total compensation is paid for services performed in the United States by actors, directors, producers, and other relevant production personnel; and (2) the production property is a film or video tape. I.R.C. § 181(d). There are limits to the deduction, and these limits differ depending on when production commenced. As originally enacted, the election to deduct costs applied to productions with an aggregate cost (direct and indirect costs of producing the work) that did not exceed \$15,000,000. I.R.C. § 181(a)(2). (This dollar limitation increased to \$20,000,000 if the production costs were “significantly incurred” in designated low-income or distressed communities.) *Id.* As a result of recent changes made by the Emergency Economic Stabilization Act of 2008, the dollar limitation has been modified. For qualified film and television productions commencing after December 31, 2007, the election to expense production costs (which would otherwise have to be capitalized) applies to the first \$15 million (or the higher \$20 million) expended for any and all qualified productions regardless of the eventual total costs. I.R.C. § 181(a)(2)(A). As a result, the § 181 election no longer applies to only low-to middle-budget films. Note that in 2011 the IRS and Treasury Department published final regulations under § 181, which clarify several aspects of the deduction. *See* Treas. Reg. § T.D. 9551; 2011-47, I.R.B. 774. Note also that the deduction under § 181 is temporary and will not apply to the cost of producing qualified film and television productions for which principal photography begins after 2011. I.R.C. § 181(f). Bills have been introduced that would amend and make permanent the § 181 election.

It should be remembered that a taxpayer may deduct qualified film production costs under section 181 only if the taxpayer is involved in a trade or business of film production under section 162. Once that issue is resolved, then the issue turns to whether the taxpayer properly elected to immediately deduction production costs under section 181, rather than to capitalize them. Of course, production expenditures must be adequately substantiated. In a recent case, *Storey v. Commissioner*, T.C. Memo 2012-115, the Tax Court first held that an attorney who made a documentary film was engaged in the trade or business of film production under section

162 and engaged in that business for profit. The court then held that the taxpayer properly elected to immediately deduct production costs under section 181.

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A recent case citing *Vitale* is *Calarco v. Commissioner*, T.C. Summary Opinion 2004-94. The taxpayer in *Calarco*, a theatre professor who wrote plays, deducted his playwriting expenses. His activity was reminiscent of the taxpayer's activity in *Vitale*: he had engaged in extensive research, generated large deductions, and claimed that his intent was ultimately to achieve a profit. The Service disallowed the deductions on the basis that the taxpayer's playwriting did not constitute a trade or business. The Tax Court applied the nine factors in the regulations under § 183 and concluded that the taxpayer carried on his playwriting with the objective of making a profit. As a result, § 183 did not limit his deductions. *See also* *Christine v. Commissioner*, T.C. Memo 2010-144 (June 30, 2010) (holding a writer for the *Los Angeles Times* had a bona fide intention to derive a profit from his author activities, and that his employment with the *Times* did not preclude the possibility that his writing activity constituted a separate trade or business); *Storey v. Commissioner*, T.C. Memo 2012-115 (holding that an attorney who made a documentary film was involved in the trade or business of film production and was engaged in that business for profit). Compare *Calarco*, *Christine*, and *Storey* with *Kanofsky v. Commissioner*, T.C. Memo 2006-79 (Apr. 18, 2006), a recent Tax Court case disallowing business deductions claimed by a full-time physics professor. *See also* *Xiong v. Commissioner*, T.C. Summ. Op. 2007-96 (June 14, 2007) (holding that a university professor was not entitled to deduct business expenses related to his authorship of a book, concluding that the book writing project was not a separate trade or business but rather was an outgrowth of his university teaching and research); *Wesley v. Commissioner*, T.C. Memo 2007-78 (Apr. 2, 2007) (holding that an individual could not deduct the expenses from his recording and music-producing activities because he was not engaged in a trade or business); *Wilmot v. Commissioner*, T.C. Memo 2011-293 (denying an individual's tax deduction for expenses related to his photography activity).

Home Office Deductions. As a general rule, expenses associated with maintaining a household (e.g., water, utilities, cleaning services, insurance, and depreciation) are non-deductible personal expenses under § 262. But what if a taxpayer, such as a freelance author or artist, uses part of his home as an office to conduct business (i.e., writing or painting)? Should a portion of the household expenses attributable to maintaining the home office be deductible as a trade or business expense under § 162?

The general rule of § 280A disallows deductions for a dwelling unit used by the taxpayer as a residence. I.R.C. § 280A(a). However, later subsections create important exceptions. Expenses such as property taxes and mortgage interest are deductible without regard to personal or business use. I.R.C. § 280A(b). To deduct other expenses for conducting business activities from a home, a taxpayer must use part of the home *exclusively* and *regularly* as the taxpayer's *principal place of business* for conducting any trade or business activity. I.R.C. § 280A(c)(1).

Whether a home office constitutes the taxpayer's principal place of business has been the subject of much litigation. In 1993, the Supreme Court, in *Soliman v. Commissioner*, considered conflicting lower court standards and developed a facts and circumstances test, stressing two primary considerations: "the relative importance of the activities performed at each business location and the time spent at each place." 506 U.S. 168, 174-75 (1993). In a recent case, the Tax Court applied the *Soliman* test and held that a university professor's use of his home for a book writing project did not qualify it as a home office. See *Xiong v. Commissioner*, T.C. Summ. Op. 2007-96 (June 14, 2007). See also *Christine v. Commissioner*, T.C. Memo 2010-144 (June 30, 2010) (disallowing the home office deduction for an employee at the Los Angeles Times who was also engaged in book writing activities).

If a home office qualifies as a taxpayer's principal place of business, the deductions allowed must be determined. As noted above, certain expenses, such as real estate taxes and home mortgage interest are fully deductible without regard to the use of a home as a trade or business. Other expenses, for keeping up and running the home (e.g., insurance, utilities, general repairs and maintenance, depreciation) are partially deductible. The deductions are limited based on the percentage of the home used for business. A common method to determine the percentage of a home used for business is to divide the square footage of the home office by the square footage of the total home.

It should be noted that section 280A(c)(5) limits the amount of otherwise deductible expenses, such as insurance, utilities, and depreciation, that are allocable to the home office. As a general rule, the total amount of these deductions may not exceed the gross income from the business (reduced by both the business expenses not allocable to use of the office and the business portion of expenses deductible without regard to business use of a home (e.g., real estate taxes and home mortgage interest allocable to the office). Any deductions disallowed may be carried over to the succeeding tax year. The section 280A(c)(5) overall limitation on home office deductions applied to a taxpayer in *Gamblin v. Commissioner*, T.C. Summ. Op. 2007-96 n.5 (June 14, 2007) (disallowing an inventor any home office deduction because he did not receive gross income from his inventing activity for the years at issue).

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In *TG Missouri Corp. v. Commissioner*, 133 T.C. No. 13 (Nov. 12, 2009), a case of first impression, the Tax Court held that the amounts paid by an automobile parts manufacturer for production molds (purchased from third-party toolmakers and later sold to customers) were not assets of a character subject to the allowance for depreciation for purposes of section 174(c) as the taxpayer did not have an economic interest in them and could not depreciate them.

In recent Field Attorney Advice (FAA), the Service concluded that section 174 does not apply to statutory stock options exercised by research and development employees. FAA 20094301F (released Oct. 23, 2009).

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The Tax Court recently addressed whether research and development expenditures incurred by a computer software developer were incurred in a trade or business and, thus, deductible under § 174. In *Saykally v. Commissioner*, T.C. Memo 2003-152, *aff'd unpublished per curiam decision*, No. 05-75128 (9th Cir. Sept. 7, 2007), the taxpayer, who had extensive technical expertise in the computer software industry, entered into an agreement with his wholly-owned corporation, which was engaged in the marketing of software products. Under the agreement, the taxpayer would create and own developed technology and would license the developed technology to his wholly-owned corporation in exchange for royalties. The corporation would market the developed technology to its customers. The taxpayer deducted his research and development expenditures on his tax return. The IRS disallowed the deductions on the ground that they were not incurred in a trade or business.

The Tax Court held that the software developer was not entitled to current deductions under § 174. According to the court, the taxpayer did not intend to market the developed technology himself, but rather intended to market the technology through his wholly-owned corporation. The taxpayer did not have the objective intent to enter into a future business of his own with the developed technology. Rather, the taxpayer's purpose for engaging in the software development was to create the developed technology that could be licensed to the corporation for use in the corporation's existing business. In other words, the taxpayer's research and development activities amounted to nothing more than the development of property rights that he intended to license to another company for use in that company's trade or business. The Ninth Circuit, in an unpublished per curiam decision, recently affirmed the Tax Court's decision that denied the § 174 deductions. No. 05-75128 (9th Cir. Sept. 7, 2007), *available at* 2007 TNT 175-47.

Compare *Saykally* with the facts presented in a recent IRS Field Attorney Advice (FAA). In FAA 20055203F (Dec. 30, 2005), the IRS concluded that a company formed to develop and market inventions could deduct its research and experimental expenditures under § 174. In the FAA, the taxpayer utilized the research results in its own trade or business by licensing such results to other parties and earning revenue therefrom.

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Replace Rev. Proc. 99-49, 1999—2 C.B. 725, with Rev. Proc. 2008-52, 2008-36 I.R.B. 587 (providing procedures under which a taxpayer may obtain automatic consent to change its treatment of research and experimental expenditures).

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Part C: In 2004, the Service published regulations on the optional 10-year write-off of research and experimental expenditures. Treas. Reg. § 1.59-1. Effective for tax years ending on or after December 22, 2004, the regulations provide guidance for making and revoking elections under § 59(e). *See* Priv. Ltr. Rul. 201042009 (granting an extension to file an election for the optional 10-year write-off under section 59(e)).

Part D: There are other examples in which an administrative pronouncement permits a write-off of capitalized creation costs that are not otherwise amortizable under the Code. Revenue Procedure 2004-36, for example, provides filmmakers a ratable 15-year write-off of creative property costs for potential future film development, production, and exploitation. More specifically, costs of acquiring or developing screenplays, scripts, story outlines, motion picture production rights to books and plays, etc. that are not set for production as films within three years, but that are not abandoned, can be amortized ratably over a 15-year period. Rev. Proc. 2004-36, 2004-1 C.B. 1063. Revenue Procedure 2004-36 is a backstop to Revenue Ruling 2004-58, which disallows filmmakers an abandonment loss deduction under § 165 when a script or screenplay is not turned into a film. Rev. Rul. 2004-58, 2004-1 C.B. 1043. As further example, recently finalized regulations provide a 15-year safe harbor amortization period for certain created intangibles that do not have readily ascertainable lives. Treas. Reg. § 1.167(a)-3(b). Therefore, capitalized costs of creating trade secrets would be eligible for 15-year write-off even though self-created trade secrets are not § 197 intangibles and do not have limited lives.

As explained in Chapter 5, Congress recently enacted a special, temporary amortization rule for songwriters. Specifically, taxpayers could elect prior to 2011 to amortize the capitalized costs (those not treated as “qualified creative expenses” to which § 263A(h) applies) of creating musical works over five years. The temporary amortization provision did not apply to other artists, such as novelists, painters, and sculptors.

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In its current form, the research credit is actually made up of three components. The amount of the credit is equal to the sum of: (1) 20% of the excess (if any) of the “qualified research expenses” for the current taxable year over a “base amount”; (2) 20% of the “basic research payments” made during the year to universities and other qualified organizations (available only to C corporations); and (3) 20% of payments made during the year to an energy research consortium for qualified energy research. I.R.C. § 41(a)(1)-(3). The first component, commonly known as the general research credit or the incremental research credit, is discussed more fully below.

In January 2004, after considering comments received and statements made at a public hearing, the Treasury issued final regulations under § 41. T.D. 9104, 69 Fed. Reg. 22-01 (Jan. 2, 2004). The final regulations are effective for taxable years ending on or after December 31, 2003. Treas. Reg. § 1.41-4(e). For taxable years ending before December 31, 2003, the IRS will

not challenge tax return positions consistent with these final regulations. Preamble, 69 Fed. Reg. 22, 26.

These final regulations generally retain the provisions of the December 2001 proposed regulations, but clarify the provisions relating to the “process of experimentation” requirement in § 41(d)(1)(C).

It should be noted that the final regulations do not contain final rules for research with respect to internal-use software for purposes of § 41(d)(4)(E). Preamble, 69 Fed. Reg. 22. As a result, taxpayers can rely on the prior suspended regulations (issued in January 2001) or the proposed regulations (issued in December 2001) for research with respect to internal-use software until final regulations are issued governing internal-use software.

[Note on Computation of the Credit: Although detailed computation methods are beyond the scope of this Chapter, it should be noted that the *general research credit* is incremental in that it is equal to a certain percentage of qualified research spending above a base amount, which can be thought of as a firm’s normal level of research and development investment. The incremental nature of the credit provides an incentive for increasing research and development expenditures over time. See I.R.C. § 41(a)(1). As an alternative to using the incremental research credit, a taxpayer may elect to use the *alternative incremental research credit*. The alternative incremental research credit does not rely on a research intensity ratio, but instead is based on the extent to which current year research expenses exceed certain percentages of the taxpayer’s average annual gross receipts for the four taxable years preceding the current year. See I.R.C. § 41(c)(4). For taxable years ending after December 31, 2006, taxpayers may, at their election, compute the research credit under a third method—the *alternative simplified credit method*—in lieu of the regular credit or the alternative incremental credit. The alternative simplified credit is an amount equal to 12% (14% for tax years ending on or after January 1, 2009) of the amount by which the qualified research expenses exceed 50% of the average qualified research expenses for the three preceding taxable years. I.R.C. § 41(c)(5). For taxpayers with no qualified research expenses for the last three years, the amount of the alternative simplified credit is equal to 6% of the qualified research expenses for the current year. *Id.* In June 2008, the Service published proposed regulations (simultaneously released as temporary regulations) on the election and calculation of the alternative simplified credit under § 41(c)(5).

Note that the alternative incremental credit has been terminated for tax years beginning after December 31, 2008, as a result of the Emergency Economic Act of 2008. See I.R.C. § 41(h)(2), as re-designated and added by the Emergency Economic Act of 2008. Those claiming the credit using this method will have to use either the basic method or the new alternative simplified credit method, both of which are discussed above.]

[Note on Documentation Required for the Credit: If a taxpayer fails to provide adequate documentation to substantiate otherwise qualified research and development costs, should a court estimate the allowable credit? In *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), the

Second Circuit established a long-standing general rule that in the case of unsubstantiated expenses, the trial court should approximate the expenses. In a recent case, the Fifth Circuit Court of Appeals made it clear that the *Cohan* doctrine is applicable to the research and development credit, and that the court should “look to testimony and other evidence including the institutional knowledge of employees, in determining a fair estimate.” *United States v. McFerrin*, No. 08-20377 (5th Cir. June 9, 2009). Recently, the Tax Court allowed a taxpayer to use estimates to determine its allowable research credit. *See Union Carbide Corp. v. Commissioner*, T.C. Memo 2009-50 (Mar. 10, 2009). These decisions are especially significant for smaller research companies that do not have the same level of supporting documentation as larger research companies. *But see Shami v. Commissioner*, T.C. Memo 2012-78 (determining that wages paid to employees of a corporation that developed products did not qualify as research expenses for purposes of the section 41 credit because wage allocations were not adequately substantiated).]

[Note on Temporary Nature of the Credit: The § 41 research credit has been continually renewed as a temporary provision. It expired on December 31, 2009, as it has several times since its creation, but then it was extended for two years through December 31, 2011. I.R.C. § 41(h)(1)(B), as amended by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312). Over the years, legislation has been introduced that would enhance and/or make permanent the research credit. At least twelve bills to revise the credit were introduced in the first session of the 112th Congress. *See Gary Guenther, Research Tax Credit: Current Law, Legislation in the 112th Congress, and Policy Issues*, Congressional Research Service (Mar. 7, 2012). Most recently, President Obama proposed in his fiscal 2013 budget that the credit be permanently extended and increased from 14 percent to 17 percent. *Id.*

Pages 106-107:

Prior to issuance of the final regulations in 2004, the controversial “discovery test,” or some form of it, had been used frequently by the IRS and several courts to disallow research credits, even though it was based on a strained interpretation of the statutory language of § 41(d) and lacked support in the legislative history. *See United Stationers, Inc. v. United States*, 982 F. Supp. 1279 (N.D. Ill. 1997), *aff’d*, 163 F.3d 440 (7th Cir. 1998). For more recent cases, see *Tax and Accounting Software Corp. v. United States*, 301 F.3d 1254 (10th Cir. 2002) (holding that there is an independent discovery requirement (test) in the multi-part test for research credit eligibility that must be satisfied before expenses can qualify for the research credit); *Wicor, Inc. v. United States*, 116 F. Supp.2d 1028 (E.D. Wis. 2000), *aff’d*, 263 F.3d 659 (7th Cir. 2001); *Norwest Corp. and Subsidiaries v. Commissioner*, 110 T.C. 454 (1998).

In a welcomed development, the final regulations issued in 2004 put to rest the controversial “discovery test” and eliminated the requirement that qualified research be undertaken to “obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering” Preamble, 66 Fed. Reg. 66363. Instead, the final regulations repeat the requirement from Treas. Reg. § 1.174-2(a)(1) by

stating that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. *Id.* According to Treas. Reg. § 1.174-2(a)(1), “uncertainty” exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. As stated in the Preamble, “there should be no ‘discovery’ requirement in the research credit regulations separate and apart from that already required under § 1.174-2(a)(1).” Preamble, 66 Fed. Reg. 66363. In a recent case, the Fifth Circuit Court of Appeals overturned a district court, finding the lower court erred in inappropriately applying the outdated “discovery” test. *See United States v. McFerrin*, No. 08-20377 (5th Cir. June 9, 2009).

As under the prior suspended regulations, the final regulations provide a patent safe harbor, under which the issuance of a patent is conclusive evidence that a taxpayer has discovered information that is technological in nature and is intended to eliminate uncertainty concerning the development or improvement of a business component. Treas. Reg. § 1.41-4(a)(3)(iii). The patent safe harbor has not been extended to encompass the process of experimentation requirement, discussed below. Accordingly, some commentators have questioned what purpose the patent safe harbor serves given that the regulations abandon the discovery test. *See Christopher J. Ohmes, David S. Hudson, & Monique J. Migneault, Final Research Credit Regulations Expected to Immediately Affect IRS Examinations*, TAX NOTES, Feb. 23, 2004, at 1015, 1018.

Pages 107-108:

The final regulations issued in 2004 provide that “a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer’s research activities.” Treas. Reg. § 1.41-4(a)(5). In contrast to the prior suspended regulations, the final regulations provide that activities to establish the appropriate design of a business component may qualify for the credit. *Id.*

The final regulations set out the core elements of a process of experimentation for purposes of the research credit:

1. A taxpayer is required to identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer’s research activities.
2. A taxpayer is required to identify one or more alternatives intended to eliminate that uncertainty.
3. A taxpayer is required to identify and conduct a process of evaluating the alternatives (e.g., modeling, simulation, or systematic trial and error).

Id. Although the final regulations set out these core elements of a process of experimentation, the regulations do not provide much guidance as to how they are to be applied in a given factual

situation. According to the Preamble, all the facts and circumstances of a taxpayer's research activities will be taken into account, and the core elements do not necessarily have to occur in a strict, sequential order: "A process of experimentation is an evaluative process, and as such, often involves refining throughout much of the process the taxpayer's understanding of the uncertainty the taxpayer is trying to address, modifying the alternatives being evaluated to eliminate that uncertainty, or modifying the process used to evaluate those alternatives." Preamble, 69 Fed. Reg. 22, 24.

As continues to be clear, the requirements for a process of experimentation under § 41 continue to be more stringent than the requirements for research and development in the experimental or laboratory sense under § 174. Indeed, the final regulations state that the mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve the new or improved business component constitute a "process of experimentation," even if the taxpayer does achieve the new or improved business component. Treas. Reg. § 1.41-4(a)(5)(i). And, as stated in the Preamble, "merely demonstrating that uncertainty has been eliminated (e.g., the achievement of the appropriate design of a business component when such design was uncertain as of the beginning of a taxpayer's activities) is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement." Preamble, 69 Fed. Reg. 22, 24.

As with the prior suspended regulations, the final regulations issued in 2004 provide that the "substantially all" requirement is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied basis, constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality of a business component. Treas. Reg. § 1.41-4(a)(6). The final regulations clarify that the "substantially all" requirement can be satisfied even if some portion of a taxpayer's activities are not for a qualified purpose (e.g., relating to style, taste, cosmetic, or seasonal design factors). *See id.*; *see also id.* § 1.41-4(a)(8), Example 4. For a recent case finding that more than 80% of costs were for experimentation and qualified research, and, thus, allowing research credits related to the design and construction of ships, see *Trinity Industries, Inc. v. United States*, No. 3:06-cv-00726 (N.D. Tex. 2010).

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The final regulations issued in 2004 did not contain final rules for research with respect to internal use software. Preamble, 69 Fed. Reg. 22. Instead, on February 9, 2004, the Treasury issued an Advance Notice of Proposed Rulemaking ("ANPRM") providing a list of issues the IRS and Treasury have considered relating to internal-use software and requesting further comments relating to internal-use software. Announcement 2004-9, 2004-1 C.B. 441 (Feb. 9, 2004). The IRS and Treasury have requested comments from the public specifically "concerning a definition of internal-use software that appropriately reflects the statute and legislative history, can be readily applied by taxpayers and readily administered by the IRS, and

is flexible enough to provide continuing application into the future.” *Id.* Several commentators have expressed skepticism over whether the IRS and Treasury might seriously attempt to promulgate internal-use software rules. *See Ohmes, Hudson, Migneault, Final Research Credit Regulations Expected to Immediately Affect IRS Examinations*, TAX NOTES at 1015, 1016 (Feb. 23, 2004) (anticipating “that the lack of guidance concerning the internal-use software rules will make it difficult to resolve cases, and may enable the IRS to continue to use its practice of resolving controversies involving research credits for internal-use software unfavorably for taxpayers”).

Until final regulations are issued governing internal-use software, the ANPRM permits taxpayers to rely on either the prior suspended regulations (issued in January 2001) or the proposed regulations (issued in December 2001) for research with respect to internal-use software.

Numerous comments regarding the definition of internal-use software have been submitted to the IRS and Treasury. These comments have suggested many alternative tests to the “separately stated consideration” standard of the proposed regulations. Many commentators arguing against the “separately stated consideration” standard of the proposed regulations urge that the test is a poor indication of internal-use and is over inclusive. Many commentators support a narrower definition of internal-use software, pointing to:

technological advancements and changes to the role of computer software in business activities since the exclusion for internal-use software was enacted in 1986, including the increased development of computer software by taxpayers, the increased use of computer software in all aspects of business activity, and the role of computer software (often integrated across a business) in providing goods and services in addition to the internal operations of a business.

Announcement 2004-9, 2004-1 C.B. 441.

Pages 109-110:

Many comments received in response to the ANPRM have addressed the definition of innovativeness in addition to the general definition of internal-use software. Several commentators have argued that the definition of innovative in the proposed regulations, which states that software is innovative “if the software is intended to be unique or novel,” is inconsistent with the legislative history, and that the subjective nature of the test will make it a new discovery test. It has been argued that the objective definition of innovativeness set forth in the prior suspended regulations, which states that software is innovative “if the software is intended to result in reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant,” should be maintained. *See Group Asks to Speak at Hearing on Proposed Research Credit Regs*, 2002 TNT 83-17 (Mar. 6, 2002).

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[Insert the following as a new section “F”.]

F. Interaction Between Section 41 and Section 174

It might be possible for research expenses to qualify for the credit under § 41 as well as the deduction under § 174. In such a case, to the extent a credit is taken under § 41, deductions under § 174 must be reduced pursuant to § 280C. I.R.C. § 280C(c)(1). Even if deductions are not taken under § 174, but rather are capitalized, the amount capitalized must be reduced by the amount of any research credit under § 41. I.R.C. § 280C(c)(2).

It should be noted that a taxpayer can elect to claim a reduced research credit under § 41 and thereby avoid a reduction of the § 174 deduction. I.R.C. § 280C(c)(3). The election to claim a reduced credit often makes sense “because the section 174 deduction affects a taxpayer’s federal taxable income, which in turn may affect its state tax liability, charitable contribution limit, alternative minimum tax, and foreign tax credit limitation.” Amy S. Elliott, *Proposed Regs Solidify Reduced Research Credit Election Mechanics*, TAX NOTES TODAY (July 16, 2009, available at 2009 TNT 134-2. In 2004, the IRS and Treasury requested public comment on regulations relating to the manner of making this election under § 280C(c)(3). In 2009, the IRS and Treasury issued proposed regulations that amend the regulations concerning taxpayers who make the election. 74 Fed. Reg. No. 135 (July 15, 2009) (requiring election to be on I.R.S. Form 6765).

For more on the § 41 research credit, see Gary Guenther, *Research Tax Credit: Current Status and Selected Issues for Congress*, CONGRESSIONAL RESEARCH SERVICE (Feb. 5, 2010), available at www.crs.gov.

Page 154:

In January 2004, the Service issued final regulations under § 263 that provide comprehensive rules for capitalization of amounts paid to acquire intellectual property and other intangible assets. See Treas. Reg. § 1.263(a)-4. The final regulations, which apply to amounts paid or incurred on or after December 31, 2003, adopt with some minor revisions the proposed regulations that were issued in December 2002. *Id.* § 1.263(a)-4(o). See pages 1-3 of this Supplement for a summary of the final regulations.

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The Service recently considered whether the acquisition of trademarks constituted the acquisition of a trade or business for purposes of § 197. In Private Letter Ruling 200416002, the

taxpayer purchased two patents from a seller, along with certain associated trademarks. The taxpayer represented that it would have paid the same amount for the patents regardless of whether or not the associated trademarks were transferred with the patents in the transaction. Further, no price was separately negotiated for the trademarks associated with the patents. The Service ruled that the purchase of the patents and the trademarks did not constitute the acquisition of a trade or business and, therefore, the patents and the trademarks did not constitute § 197 intangibles. Priv. Ltr. Rul. 200416002 (Dec. 19, 2003, released Apr. 16, 2004).

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It should be noted that the issue of whether readily available (“off-the-shelf”) software is amortizable under some applicable amortization provision is irrelevant if a purchaser chooses to take advantage of § 179. The Jobs and Growth Tax Relief Reconciliation Act of 2003 added off-the-shelf software to the list of qualified tangible assets that can be immediately expensed under the special rule of § 179 rather than be capitalized and amortized. Only off-the-shelf software purchased in a tax year beginning after 2002 and before 2013 qualifies for the special deduction under § 179. I.R.C. § 179(d)(1)(A). For tax years beginning in 2012, the maximum allowable deduction for all qualified property placed in service is \$125,000. I.R.C. § 179(b)(1). This number is actually adjusted for inflation to \$139,000. I.R.C. § 179(b)(6). The maximum amount is reduced dollar-for-dollar (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds \$500,000 (inflation adjusted to \$560,000). I.R.C. § 179(b)(2). The amount eligible to be expensed cannot exceed the taxable income derived by the taxpayer from the active conduct of any trade or business, with any disallowed deductions due to this limitation permitted to be carried forward. I.R.C. § 179(b)(3). For tax years beginning after 2012, the section 179 maximum deduction will be reduced to \$25,000 and the phase-out will start at \$200,000, absent further congressional tinkering.

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In an “applicable asset acquisition,” the purchaser and seller must allocate total consideration under the so-called “residual method.” Under the residual method of allocation, overall consideration is allocated to seven different classes of assets in sequence. Consideration is first allocated to *Class I assets*, which are cash and general deposit accounts, in an amount equal to the face amount of that cash and cash equivalents. The remainder of the consideration is then allocated to *Class II through Class VI assets*, which are identifiable tangible and intangible assets, in proportion to, but not in excess of, the fair market value of those assets. Any residual or leftover consideration is finally allocated to *Class VII assets*, which are goodwill and going concern value. An allocation to any particular tangible or intangible asset cannot exceed the asset’s fair market value. Treas. Reg. § 1.338-6(c)(1).

The residual method of allocation under § 1060 does not necessarily eliminate disputes between taxpayers and the IRS. Buyers must still value transferred assets, not an easy task with

respect to certain forms of acquired intellectual property. Further, buyers (and their cooperative appraisers) have an incentive to place higher values on depreciable or amortizable assets with shorter recovery periods in order to maximize the buyer's depreciation and amortization deductions. As a general rule, a written agreement between the transferor and transferee allocating the fair market value of assets purchased is binding on the parties and controlling for tax purposes, unless the IRS determines the fair market value allocations are not appropriate. I.R.C. § 1060(a)(2); *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967). The IRS has the ability to challenge a taxpayer's determination of fair market value of any asset by any appropriate mean. *See* H.R. Rep. No. 213, 103d Cong., 1st Sess. 255 (1993).

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Worthlessness of Section 197 Intangibles. As a general rule, a taxpayer may claim a deduction under section 165 if and when intellectual property becomes worthless. I.R.C. § 165(a). The amount of the loss deduction, however, is subject to any provision of the Code that prohibits or limits the amount. Treas. Reg. § 1.165-1(a). One such provision, section 197(f)(1), states that if there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained, then: (1) no loss may be recognized; and (2) appropriate basis adjustments must be made to the retained intangibles. I.R.C. § 197(f)(1); Treas. Reg. § 1.197-2(g)(1). The abandonment of an amortizable section 197 intangible, or any other event rendering it worthless, is treated as a disposition of the intangible for purposes of section 197(f)(1). Treas. Reg. § 1.197-2(g)(1)(i)(B). For a recent Field Attorney Advice applying section 197(f)(1), see FAA 20111101F (Feb. 15, 2011).

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A recent Tax Court case illustrates the eligibility requirements under section 167. In *Rooney v. Commissioner*, T.C. Memo 2011-14 (Jan. 18, 2011), the taxpayer, who was in the trade or business of being a film director, writer, and producer, claimed depreciation deductions for research library and other materials he purchased. The Tax Court disallowed the depreciation deductions because the expenditures were personal—to enhance the taxpayer's personal collection rather than to carry on his business as a producer and filmmaker. Taxpayer also failed to prove that some of the purchased items had a limited economic useful life or were subject to wear and tear, decay, or obsolescence as a result of their use.

Page 158:

Because of the disparate treatment between software *development* costs (immediately deductible under Revenue Procedure 2000-50) and software *acquisition* costs (amortized over

either fifteen years under § 197 or three years under § 167(f)), considerable controversy has arisen over how to distinguish between the two categories. For example, how does one classify certain installation and customization work related to the acquisition of certain software? Much of the controversy stems perhaps from a recent ruling from the Service. In Private Letter Ruling 200236028, the Service concluded that some of the installation and customization work related to the acquisition of “enterprise resource planning” (ERP) software would be treated as part of the acquisition costs and, thus, would be ineligible for immediately expensing as development costs. Priv. Ltr. Rul. 200236028 (Sept. 6, 2002) (describing ERP software as “a shell that integrates different software modules for financial accounting, inventory control, production, sales and distribution, and human resources”). The Service ruled that the costs to purchase the ERP software were “acquisition” costs subject to three-year amortization under § 167(f)(1). More interestingly, the Service ruled that certain technical consulting costs (that portion for selecting options and embedded templates from the ERP module to meet the taxpayer’s business needs) were not software development costs, but were part of the software acquisition costs that had to be capitalized. *Id.* (ruling that these technical consulting costs “do not meet the machine readable code requirements of Rev. Proc. 2000-50”).

In the final regulations under § 263, issued in January 2004, the IRS and Treasury refused to provide guidance relating to the development and implementation of computer software. The Preamble to the regulations notes:

While these final regulations require a taxpayer to capitalize an amount paid to another party to acquire computer software from that party in a purchase or similar transaction, nothing in these regulations is intended to affect the determination of whether computer software is acquired from another party in a purchase or similar transaction, or whether computer software is developed or otherwise self-created (including amounts paid to implement Enterprise Resource Planning (ERP) software). While the proposed regulations identify ERP implementation costs as an issue to be addressed in the final regulations, the IRS and Treasury Department believe that rules regarding the treatment of such costs are more appropriately addressed in separate guidance dedicated exclusively to computer software issues. Until separate guidance is issued, taxpayers may continue to rely on Revenue Procedure 2000-50.

Preamble, 68 Fed. Reg. 436, 440 (citations omitted).

Pages 158-159:

Proposed regulations under § 167 defined current year income as the income from an income-forecast property for such year *less the distribution costs* of the income-forecast property for such year (i.e., net income from the property). Prop. Treas. Reg. § 1.167(n)-3(a)(1). The American Jobs Creation Act of 2004, however, clarified that *gross income* should be used for the computation and that distributions costs should not be taken into account for purposes of

determining income with respect to a property. I.R.C. § 167(g)(5)(E), as added by the American Jobs Creation Act of 2004.

The American Jobs Creation Act of 2004 clarified that a taxpayer may include participations and residuals in the adjusted basis of a property in the tax year that it is placed in service (but only to the extent that the participations and residuals relate to income estimated to be earned in connection with the property before the close of the tenth tax year after the tax year in which the property was placed in service). I.R.C. § 167(g)(7)(A), as added by the American Jobs Creation Act of 2004. In the alternative, under the 2004 Act a taxpayer may exclude the participations and residuals from the adjusted basis of the property and deduct them in full in the year that they are actually paid. I.R.C. § 167(g)(7)(D)(i), as added by the American Jobs Creation Act of 2004.

Pages 158-159:

Expired Amortization Rule for Musical Property. Section 167(g) was amended by the Tax Increase Prevention and Reconciliation Act of 2005 to provide a special, temporary amortization rule for musical works. Under temporary § 167(g)(8), taxpayers may elect to amortize the capitalized costs of creating or acquiring “applicable musical property” over five years in lieu of amortizing the costs under the income-forecast method. The term “applicable musical property” means any musical composition (including any accompanying words), or any copyright with respect to a musical composition. I.R.C. § 167(g)(8)(C). The special amortization provision for musical works applies with respect to property placed in service in taxable years beginning after December 31, 2005, but an election may not be made for any tax year beginning after December 31, 2010. I.R.C. § 167(g)(8)(E). The special amortization rule applies only to capitalized costs and does not apply to costs that are treated as “qualified creative expenses” and deducted under the special rule to which § 263A(h) applies. Legislation has been introduced to permanently extend the five-year amortization period for expenses incurred while creating music or music copyrights.

Page 162:

The personal holding company tax is now equal to 15% of the “undistributed personal holding company income” of every “personal holding company.” I.R.C. § 541.

In Private Letter Ruling 200843013 (July 14, 2008), the Service ruled that royalties received from the licensing of software were excluded from the personal holding company rules since they fell within the exception for active business computer software.

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In a recent case, the Tax Court addressed whether a company sold software or merely licensed software for tax purposes. In *Vision Information Services LLC v. Commissioner*, T.C. Memo 2004-53 (Mar. 8, 2004), a software developer (Nordic Information Systems, Inc.) granted to the taxpayer (Vision Information Services, LLC) “an exclusive perpetual worldwide license” to use software developed by Nordic. The agreement stated that the license to the taxpayer was “not a sale” and that all proprietary rights to the developed software were held by Nordic. The agreement also allowed the taxpayer to sublicense the software to Twentieth Century Fox (Fox Video) for its use. Accordingly, the taxpayer entered into a “software license agreement” with Fox Video, under which the taxpayer sub-licensed the software to Fox Video to use the software to process its own data and the data of its affiliates. Pursuant to this latter agreement, the taxpayer received a \$3 million payment in 1995 and a \$1.75 million payment in 1996, and reported each as long-term capital gain from the sale of the software. The IRS concluded that both payments were taxable as ordinary income because they were received by the taxpayer as a license fee.

The Tax Court looked to the intent of the parties as of the time that they entered into the agreements in determining whether the taxpayer sold or licensed to Fox Video the software underlying the payments. The agreement stated that the license to the taxpayer was “not a sale.” The Tax Court questioned how the taxpayer could have sold the software to Fox Video when the software was not owned, but merely licensed, by the taxpayer. The court read the agreement between the taxpayer and Fox Video to provide similarly that the taxpayer licensed and did not sell the software to Fox Video. In fact, the agreement provided that the taxpayer sublicensed the software to Fox Video and would in return be receiving a “license fee.” In conclusion, the Tax Court held that the transaction between the taxpayer and Fox Video was a licensing agreement and, as a result, the disputed payments were taxable as ordinary income.

Page 185:

If intellectual property is sold as part of the sale of an ongoing business, the total consideration received for the business must be allocated among the various assets in order to determine the proper tax consequences on the sale. Review *Williams v. McGowan*, included in Chapter 3. In an “applicable asset acquisition,” the total consideration must be allocated among the various assets in accordance with the rules of § 1060—the so-called “residual method” discussed more fully in Chapter 5.

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In Technical Advice Memorandum 200602034 (Sept. 29, 2005), the IRS provided guidance on intellectual property exchanges. The IRS ruled that intellectual property used predominantly in the United States and intellectual property used predominantly outside the United States are not “like-kind” property for purposes of nonrecognition treatment under § 1031. For two patents to be considered of like kind, the IRS ruled that the underlying property

must be either of the same General Asset Class under Treas. Reg. § 1.1031(a)-2(b)(2) or the same Product Class of Treas. Reg. § 1.1031(a)-2(b)(3) or otherwise of like kind. The IRS applied the same analysis to unregistered intellectual property (i.e., designs and drawings, trade secrets and secret know how).

In Technical Advice Memorandum 200602034, the IRS also ruled that trademarks and trade names should never be considered like-kind because trademarks and trade names are unique and so closely related to (if not part of) the goodwill and going concern value of a business. *See also* FAA 20074401F (Sept. 25, 2007) (ruling that exchanged newspaper mastheads, regardless of whether characterized as a trademarks or trade names, were not like-kind property since they are so closely related to (if not a part of) the goodwill and going concern value of the newspapers). The IRS, however, later changed its position with respect to trademarks and trade names by issuing a legal memorandum that supersedes the above administrative guidance. IRS Chief Counsel Advisory 200911006 (Feb. 12, 2009). Now, the IRS's position is that intangibles such as trademarks and trade names and mastheads that can be separately described and valued apart from goodwill qualify as like-kind property under § 1031. Of course, to qualify under § 1031, the property must satisfy all other requirements of § 1031 including the nature and character rules of Treas. Reg. § 1.1031(a)-2(c)(1).

Page 186:

It should be noted that the abandonment of an amortizable section 197 intangible, or any other event rendering it worthless, is treated as a disposition of the intangible for purposes of section 197(f)(1). Treas. Reg. § 1.197-2(g)(1)(i)(B). In Field Attorney Advice, 20111101F (Feb. 15, 2011), the taxpayer purchased certain assets of another automobile dealer (i.e., franchise rights to sell W, X, Y, and Z automobiles, and goodwill related to the franchise rights). Later the taxpayer received notice that its franchise rights to sell W and Y products were being terminated. The taxpayer claimed that the goodwill associated with the W and Y franchises became worthless and sought to deduct the goodwill as worthless. Not surprisingly, the Service ruled that the taxpayer's situation fell within section 197(f)(1). Because the goodwill that the taxpayer wanted to deduct as worthless was an amortizable section 197 intangible and the taxpayer retained other amortizable section 197 intangibles that were acquired in the same transaction or series of related transactions as the worthless goodwill, section 197(f)(1) prohibited any deduction for worthlessness.

Pages 187-188:

It should be noted that the inventory exclusion and the self-created copyright exclusion do not apply, at the election of the taxpayer, to musical compositions or copyrights in musical works sold, as a result of the Tax Increase Prevention and Reconciliation Act of 2005. *See* I.R.C. § 1221(b)(3). As a result, songwriters get to pay capital gains tax rates, rather than higher personal income tax rates, on sales of their songs. Capital gains treatment is not available to

other artists, such as novelists, painters, sculptors, and designers. Query: Is there any theoretical justification for this distinction? In 2011, the IRS published final regulations that describe how and when an individual may elect to treat as capital gains any income received from the sale or exchange of musical works or copyrights in musical works created by the individual. *See* Treas. Reg. § 1.1221-3.

Page 190:

In a recent Technical Advice Memorandum, the IRS applied *McClain* and *Chilton* in concluding that a university professor was entitled to capital gains treatment under § 1235 for royalties received from the university. In Tech. Adv. Mem. 200249002 (Aug. 8, 2002), a university professor developed an invention in the course of his research. He filed patent applications for the invention and then executed an assignment agreement, assigning his interest in the patent applications to the university. The professor also entered into a royalty distribution agreement with the university regarding the invention, which provided the professor would receive a certain percentage of the royalties resulting from the university's licensing of the patents. The university treated these amounts as royalty payments and not as part of the professor's salary. In the TAM, the Service looked to the facts and circumstances of the employment relationship and concluded that the payments in question were connected to the transfer of invention rights, rather than compensation for services. Among the factors considered in favor of the professor were: (1) The payments received for the rights to the invention were in addition to and separate from the professor's salary, pursuant to a separate agreement with the university; (2) continued receipt of the payments was not contingent on continued employment with the university; (3) the amount of the payments received was dependent on the use or value of the licensing of the patent; and (4) the university treated the payments as royalties, not as salary.

As explained in Chapter 8, damages for patent infringement are often treated as ordinary income. However, such infringement damages may be treated as capital gain if all valuable rights to the patent are (or have been) transferred. The regulations under section 1235 provide explicitly that section 1235 applies to amounts awarded as damages or received in settlement of a suit for compensatory damages for patent infringement. Treas. Reg. 1.1235-1(c)(1). *See* Robert W. Wood, *Patent Infringement Claims and Capital Gain*, TAX NOTES at 1179 (Feb. 27, 2012) (noting the applicability of section 1235 depends on whether the lawsuit proceeds are attributable to the transfer of patent rights).

Pages 190-191:

In 2005, the Service issued three Private Letter Rulings holding that an inventor who filed patents with two co-inventors and formed a limited liability company (LLC) with them retained his status as a "holder" for purposes of § 1235, and that any gain recognized by the LLC on disposition of the patent rights would be qualified for treatment as preferential long-term

capital gain to the members. Priv. Ltr. Rul. 200506008; Priv. Ltr. Rul. 200506009; Priv. Ltr. Rul. 200506019. In these rulings, three inventors (A, B, and C) filed several patent applications relating to a certain product. In a tax-free transaction, they transferred their respective interests in the product (including all of their interest in the patents and trade secrets, know-how, and other intellectual property associated with the product) to a newly formed LLC (treated as a partnership for tax purposes) in exchange for membership interests in the LLC. In response to a ruling request by Investor A, the Service concluded: (1) following the transfer of A's interests in the patents to the LLC, A will retain A's status as a "holder" for § 1235 purposes; and (2) provided the other requirements of § 1235 were satisfied, A's allocable share of gain recognized by the LLC on a disposition of an interest in the patents would qualify under § 1235 as long-term capital gain.

Page 193:

For a recent case holding that § 1235 did not apply to payments received from a related corporation, see *Garfield v. Commissioner*, T.C. Memo 2006-267 (Dec. 18, 2006), *aff'd*, 102 A.F.T.R.2d 2008-5803, 2008-2 USTC ¶ 50,508 (2d Cir. Aug. 18, 2008) (holding further that royalties were not long-term capital gain under general capital gain provisions—§§ 1221-1222—because the taxpayer did not hold the patent rights for the requisite long-term holding period).

Page 194:

An interesting issue is whether television and film production costs that were immediately expensed under § 181, as added by the American Jobs Creation Act of 2004, have to be recaptured at ordinary income rates under § 1245. While there was initial uncertainty concerning whether recapture applied, Congress recently clarified that it does. Qualified film and television production costs expensed under § 181 are treated as if they were deductions allowable for amortization. I.R.C. § 1245(a)(2)(C), as amended by the Gulf Opportunity Zone Act of 2005.

Page 194:

In a recent private letter ruling, for example, the Service concluded that any gain with respect to a sale of self-created customer relationships (not a section 197 intangible) will not be subject to section 1245 recapture as a result of amortization deductions claimed with respect to acquired customer relationships (a section 197 intangible). Priv. Ltr. Rul. 201016053 (Dec. 14, 2009). Taxpayer was able to establish which of its current customers represent components of either self-created customer relationships or acquired customer relationships, and each had a reasonably ascertainable value. The self-created customer relationships were a severable and distinct asset from the acquired customer relationships, such that any gain with respect to a sale of the former would not be subject to recapture as a result of section 197 amortization deductions

claimed with respect to the latter. Of course, amortization deductions claimed for the acquired customer relationships would be subject to section 1245 recapture upon disposition of such intangibles.

Page 195:

For the legislative history, and bases for competing interpretations, of section 1253, see Jeffrey L. Shore, *Sale vs. License of Franchises, Trademarks, and Trade Names*, TAX NOTES, at 79 (July 2, 2012).

Page 197:

A claim for more royalties from a licensee has no bearing on the taxability of royalties actually received. *See* *Poindexter v. Commissioner*, T.C. Memo 2005-122 (holding that a licensor's claim that he should have received more royalties (i.e., claim that he was not paid the full royalties owed by a licensee) has no bearing on determining the licensor's correct tax liability and his obligation to pay that liability).

Page 198:

In light of the *DuPont* decision, the Service no longer believes that it should maintain that all substantial rights in know how or a patent held by the transferor must be transferred in order to constitute a transfer of property for purposes of section 351. *See* Gen. Couns. Mem. 36922 (Nov. 16, 1976). *See also* Field Service Advice 1984760 (noting that a court would likely conclude that the transfer of a nonexclusive license and related technology would qualify for non-recognition treatment).

Page 199:

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 ("the 2004 Act"), which made significant changes to the charitable deduction rules for intellectual property. The 2004 Act was intended to curb improper deductions resulting from overvaluation of donated intellectual property, while continuing to encourage donations of intellectual property to qualified charities. The new legislation applies to most forms of intellectual property, including patents, certain copyrights, trademarks, trade names, trade secrets and know-how, certain software, or similar intellectual property or applications or registrations of such property. The new legislation does not apply to self-created copyrights (because prior law, enacted in 1969, already targeted such property, i.e., eliminated a fair market value standard for self-created copyrights) or off-the-shelf computer software.

The 2004 Act limits the amount of the initial charitable deduction to the lesser of the taxpayer's basis in the donated intellectual property or the fair market value of the intellectual property at the time of the contribution. I.R.C. § 170(e)(1)(B). In most cases, the lesser amount would be the donor's basis.

Although the 2004 Act lowers the initial charitable deduction, it permits a donor to take additional charitable deductions in later years based on a certain percentage of the donee's income attributable to the intellectual property. More specifically, a donor is allowed additional deductions in later years based on a specified percentage of the "qualified donee income" received or accrued by the charity from the donated property itself, rather than income stemming from the activity in which the donated property is used. I.R.C. § 170(m)(3). "Qualified donee income" is the net income that is properly allocable to "qualified intellectual property." For purposes of these future deductions, "qualified intellectual property" does not include intellectual property donated to a private foundation. I.R.C. § 170(m)(9).

The amount of the additional deduction a taxpayer may take each year is determined using a sliding-scale percentage of qualified donee income received or accrued by the charity that is allocable to the property. I.R.C. § 170(m)(1), (7). As illustrated below, the percentage decreases each year over a twelve-year period. In the first and second years after the contribution, a taxpayer can deduct 100% of the qualified donee income. In year three, a taxpayer may deduct 90% of the qualified donee income. In year ten, only 20% of the qualified donee income is deductible. The following chart shows the actual sliding scale:

Taxable Year of Donor Ending on or After Date of Contribution	Applicable Percentage
1st.....	100
2nd.....	100
3rd.....	90
4th.....	80
5th.....	70
6th.....	60
7th.....	50
8th.....	40
9th.....	30
10th.....	20
11th.....	10
12th.....	10

It should be cautioned that in order to qualify for an additional deduction in a future year, however, the aggregate of the amounts calculated using the sliding-scale must exceed the amount of the initial deduction claimed in the year the property was contributed. I.R.C. § 170(m)(2). Additional charitable deductions are not allowed with respect to any revenues or income received or accrued by the donee after the expiration of the legal life of the intellectual property.

The 2004 Act requires *donors* to inform charitable donees of their intent to treat the contribution as a “qualified intellectual property contribution” and take additional deductions in subsequent years based on the income from the donated property. I.R.C. § 170(m)(8)(B). The 2004 Act requires *charitable donees* to provide donors with written substantiations explaining the amount of their income derived from the donated intellectual property during the taxable year. I.R.C. § 6050L(b). The IRS has issued Form 8899 on which charitable donees will report qualified donee income; the donee must provide a copy of the information return to the donor. In April 2008, the IRS published final regulations that provide guidance for the filing of information returns by recipients of qualified intellectual property contributions. *See* Treas. Reg. § 1.6050L-2. In August 2008, the IRS published proposed regulations that implement recent legislative changes to the substantiation and reporting rules for charitable donations, clarifying, for example, new definitions of “qualified appraisal” and “qualified appraiser” applicable to non-cash contributions. REG-140029-07, 2008-40 I.R.B. 828 (implementing recent legislative changes made by the American Jobs Creation Act of 2004 and the Pension Protection Act of 2006).

By eliminating the fair market value standard for contributions of intellectual property, the 2004 Act will reduce the number of negligent and intentional overvaluations of intellectual property donations and, correspondingly, will reduce the administrative costs and burdens associated with overvaluations of donated intellectual property. By eliminating a fair market value approach, however, the 2004 Act has eliminated in most cases any immediate economic incentive for charitable giving of intellectual property. Without this immediate economic incentive, according to some commentators, donations of intellectual property will decrease dramatically.

[Note on Charitable Deductions of Self-Created Musical Works: Recent legislation, which allows preferential capital gains treatment on sales of musical compositions or copyrights in musical works created by the taxpayer’s personal efforts, did not change the limitation discussed here on the charitable deduction for the donation of such works. *See* I.R.C. § 170(e)(1)(A). In other words, the amount of the initial charitable deduction for the donation of self-created musical works is the lesser of the adjusted basis or fair market value. On February 10, 2009, Senator Patrick Leahy, D-Vt., introduced a bill that would provide a fair market value deduction for charitable contributions of any “literary, musical, artistic, or scholarly composition, or similar property, or the copyright thereon (or both)” created by the donor. S. 405, the Artist-Museum Partnership Act (111th Cong., 1st Sess., Feb. 10, 2009). Similar bills have been introduced in the past.]

Pages 247-251:

[Introductory Note: States have always been suspicious of related-party transactions in general and the use of IP holding companies in particular. This chapter is designed to introduce to students some of the various methods used by states to close the IP holding company tax strategy. As the materials show, some states have chosen to attack IP holding companies by

asserting constitutional nexus over them. Others have chosen to enact loophole closing legislation that nullifies the tax advantages of IP holding companies. For example, a number of states—so-called “combined reporting” states—have adopted legislation requiring unitary corporations engaged in substantial inter-company transactions to report their income on a combined basis (effectively treating the parent company and IP holding company as a single corporation for state income tax purposes). A number of other states—so-called “separate reporting states”—have enacted “addback statutes” requiring the addback of royalty deductions unless the transaction has economic substance or does not constitute a sham (effectively disallowing the parent company a deduction for royalty payments made to the IP holding company). *See* *Surtees v. VFJ Ventures, Inc.*, 2008 WL 344118 (Ala. Civ. App. Feb. 8, 2008) (requiring manufacturer to add back royalty payments). What has become even clearer since the casebook was published in 2004 is that the IP holding company model faces many uncertainties. As students read this chapter, they should think about whether the IP holding company model is still viable and, if so, steps that should be taken to minimize the risk of having royalties subject to state income tax.]

Page 247:

Geoffrey is a controversial decision. While some states have adopted *Geoffrey*, others have strongly rejected it and its reasoning. For a recent state decision following *Geoffrey*, read *Lanco, Inc. v. Director*, included in the materials below. *See also* *Bridges v. Geoffrey, Inc.*, 2008 WL 399205 (La. App. 1 Cir. Feb. 8, 2008) (holding lack of physical presence did not preclude taxation of royalty income). [For another interesting case, see *Kmart Corp. v. Taxation & Revenue Dep't of New Mexico*, 131 P.3d 22 (N.M. 2005) (holding, while declining to rule on constitutional nexus issues, that as a matter of statutory law, New Mexico's gross receipts tax does not apply to receipts generated from the licensing agreement between parent and IP holding company when all of the activities relating to the license agreement occurred outside New Mexico).]

Pages 247-249:

Replace citations for *SYL, Inc. v. Comptroller of the Treasury* and *Crown Cork & Seal, Inc. v. Comptroller of the Treasury* with *Comptroller of the Treasury v. SYL Inc.*, 825 A.2d 399 (Md. Ct. App. 2003).

Page 254:

In a recent case, the Fourth Circuit disallowed § 174 deductions to an R&D limited partnership. In *Lewin v. Commissioner*, No. 02-1169 (4th Cir. 2003) (unpublished per curiam opinion), a limited partnership with three general partners was formed to finance the research and development projects of several companies (which had already commenced the research and

development as well as preliminary work to market the developed technology). After formation, the limited partnership entered into research agreements with each of the research and development companies. Under the terms of the agreements, the limited partnership was granted comprehensive rights in the companies' existing technology and technology to be developed in the research and development projects. Each research and development company received a nonexclusive license to use the technology in exchange for royalties. In addition, each company had an option to acquire all right, title, and interest in the technology that it developed, in which case the limited partnership had an option to acquire an equity interest in the research and development company. In other words, after the research and development companies completed the research and development (and commenced marketing), the limited partnership was to receive royalties based upon gross sales with the option to convert these royalties to equity in the research and development companies. The limited partnership did not set aside funds for the manufacturing or the marketing of products developed by the research and development companies.

For the relevant tax years, the limited partnership filed information returns claiming § 174 deductions for research payments it made to the research and development companies. The IRS disallowed those deductions. After a trial, the Tax Court held that the limited partnership was not entitled to the § 174 deductions it had claimed. *I-Tech R&D Limited Partnership v. Commissioner*, T.C. Memo 2001-10. On appeal, the Fourth Circuit affirmed the Tax Court's decision and held that the limited partnership was merely an investor in the five research and development companies and was not allowed to tax deductions under § 174. The Fourth Circuit found that none of the actions undertaken by the partners were anything more than investors monitoring their investment and doing what they could to assure that it was a successful venture. The Fourth Circuit concluded that the limited partnership's goal was to secure royalty payments and equity interests in the research and development companies, and not to engage in any trade or business of its own. The limited partnership did not have any specific plans or resources to exploit or market the results of the research projects. Furthermore, the Fourth Circuit agreed with the Tax Court that the buy-out options of the research and development companies almost certainly guaranteed that the limited partnership did not have a realistic prospect of exploiting any discoveries in its own trade or business.

Pages 271-275:

Replace *SYL* with the following recent case:

Lanco, Inc. v. Director, Div. of Taxation

879 A.2d 1234 (N.J. Super. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006) (per curiam)

Pages 307-308:

The “origin-of-the-claim” test was originally created by the Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963), and used to determine whether litigation costs were incurred in a business or profit-seeking context or whether the costs were personal. The origin-of-the-claim standard has also been used to determine whether litigation costs—even if incurred in a business or profit-seeking activity—are nondeductible capital expenditures. *Woodward v. Commissioner*, 397 U.S. 572 (1970). As noted in this chapter, the origin-of-the-claim test is not a purely mechanical test; it requires more than looking merely to the taxpayer’s intent in filing the suit. One must also consider the issues involved, the nature and objectives of the litigation, the defenses asserted, the purposes for which the amounts were expended, the background of the litigation, and all facts pertaining to the controversy. The origin-of-the-claim test has been used in a number of lower court cases, many of which involve intellectual property suits.

Page 310:

It should be noted that there are no applicable Internal Revenue Code provisions exempting from taxation damages received in intellectual property suits. Clearly, § 104(a) excludes from taxation only damages received on account of personal physical injuries and physical sickness, and does not apply to business damages. In addition, the Service recently ruled that § 1033, which excludes from income proceeds from involuntary conversions, does not apply to settlement proceeds for patent infringement, copyright infringement, and misappropriation of trade secrets. Tech. Adv. Mem. 200625032 (Mar. 3, 2006).

Page 310:

For a recent decision determining the proper tax treatment of a settlement award received in a trade secret misappropriation case, see *Freda v. Comm’r*, 2009 Tax Ct. Memo LEXIS 193 (Aug. 25, 2009). The Seventh Circuit recently affirmed the Tax Court’s decision. See *Freda v. Commissioner*, 656 F.3d 570 (7th Cir. 2011). The Seventh Circuit found that the Tax Court did not err in holding that the settlement was not “in lieu of” a replacement of capital. *Id.* at 577 (“Because there was not a complete transfer of all substantial rights, there was no ‘sale’ of a capital asset or long-term capital gain resulting therefrom.” Accordingly, the settlement for the trade secret misappropriation received was ordinary income. For commentary, see Robert W. Wood, *Do You Want Capital Gain or Ordinary Income on That Pizza?*, TAX NOTES at 1293 (Sept. 19, 2011).

For a recent decision on the tax treatment of an arbitration award received by an employee for providing “ideas” to his employer, see *Bachmann v. Comm’r*, 2009 Tax Ct. Memo LEXIS (Mar. 11, 2009). In this case, Mr. Bachmann was a senior vice president at Smith Barney during the taxable year 2004. Bachmann met with James Harasimowicz, a director of Smith Barney, and presented him with “group-issuance” idea. Harasimowicz was enthusiastic about the idea and sought permission from his superiors to pursue the idea. Officials at Smith Barney approved the use of the idea and Bachmann was charged with preparing certain clients to

participate in the group-issuance idea. As a result, Smith Barney earned at least \$6 million in fees from the deal based on the idea. Bachmann did not receive any compensation from Smith Barney for the idea and subsequently filed an arbitration claim with the New York Stock Exchange against Smith Barney for unjust enrichment, misappropriation, and conversion of his novel idea. The arbitrators conducted numerous hearings and ultimately awarded Bachmann \$1,576,360. Bachmann did not include the award in his taxable income in 2004. The IRS argued that the arbitration award was ordinary income based on Mr. Bachmann's service to Smith Barney and from "implementing his idea." The Tax Court found that Bachmann failed to provide any evidence that the arbitration award should be excluded from taxable income for 2004. Bachmann failed to show that he had "a tax basis in the idea." In fact, the Tax Court was "unable to find that the idea [had] a tax basis of anything greater than zero. The Tax Court concluded that the arbitration award was payment for services Bachmann provided to Smith Barney and that the award must be included in the 2004 income at ordinary income rates.

It should be noted that although damages for patent infringement are often treated as ordinary income, such infringement damages may be treated as capital gain if all valuable rights to the patent are (or have been) transferred. Review Chapter 6 for the capital gain requirements under the special rule of section 1235 and under the general characterization rules of sections 1221/1222/1231. See Robert W. Wood, *Patent Infringement Claims and Capital Gain*, TAX NOTES at 1179 (Feb. 27, 2012) (noting the applicability of section 1235 depends on whether the lawsuit proceeds are attributable to the transfer of patent rights).

Page 311:

In post litigation, after a trademark owner has prevailed and received first a favorable jury verdict on damages and then a subsequent settlement sum, a tax-related question may arise concerning whether the jury verdict or the subsequent settlement agreement will control the allocation of the amount received from the defendants—"damage to goodwill and reputation" versus "lost profits/disgorgement of profits". In *Heathpoint v. Commissioner*, T.C. Memo 2011-241, the Tax Court held that the jury verdict, not the settlement agreement will control the allocation of the proceeds for tax purposes.

Page 348:

U.S. corporate income tax rates are higher than the corporate tax rates in many other countries, putting many U.S. corporations at a competitive disadvantage in the world marketplace. To level the international playing field, the United States enacted a series of tax benefits for U.S. exporters. But each of these tax benefits—the domestic international sales corporation (DISC) rules; the foreign sales corporation (FSC) rules; and the extraterritorial income (ETI) exclusion—was found to constitute improper export subsidies that violated international trade agreements, and each was eventually repealed. The latest tax benefit to replace the benefits of the repealed exclusion for extraterritorial income is a new deduction that

has the effect of reducing taxes applicable to certain U.S.-based manufacturing (and has significant implications for U.S. software development firms).

Section 199, added by the American Jobs Creation Act of 2004, allows a deduction equal to a phased-in percentage of the lesser of (1) the “qualified production activities income” of the taxpayer for the taxable year, or (2) taxable income for the taxable year. I.R.C. § 199(a)(1). The percentage is three percent for tax years beginning in 2005 and 2006; six percent for tax years beginning in 2007, 2008, and 2009; and nine percent for tax years beginning in 2010 and thereafter. I.R.C. § 199(a)(2). The amount of the deduction is limited annually to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year, which creates an incentive to obtain services from employees rather than outsourcing work to independent contractors. I.R.C. § 199(b)(1).

The taxpayer’s § 199 deduction depends primarily on the amount of the taxpayer’s “qualified production activities income” which is defined as “domestic production gross receipts” minus the cost of goods sold allocable to such receipts and other expenses, losses, or deductions that are properly allocable to such receipts. I.R.C. § 199(c)(1). A taxpayer’s “domestic production gross receipts” are the taxpayer’s gross receipts derived from one of several listed activities—for example, gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of “qualifying production property” that was manufactured or produced by the taxpayer in whole or in significant part within the United States. I.R.C. § 199(c)(4)(A)(i)(I). “Qualifying production property” is defined as any tangible personal property, any *computer software*, and any sound recordings. I.R.C. § 199(c)(5). The § 199 deduction may be available to computer software updates, as well as to some online software and online games. *See* T.D. 9262. *See also* Internal Legal Memorandum 201014050 (Nov. 16, 2009), *available at* 2010 TNT 69-24 (determining that gross receipts from the sale of the taxpayer’s product to distributors and wholesalers qualify as domestic production gross receipts for purposes of section 199, but that gross receipts from the licensing of intangible property do not).

The regulations provide that domestic production gross receipts include gross receipts derived from the disposition of computer software, but does not include gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services. Treas. Reg. § 1.199-3(i)(6)(i)-(ii). However, the regulations provide that if a taxpayer derives gross receipts from providing customers access to computer software produced in whole or significant part within the United States for the customers’ direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as from the disposition of computer software if one of two exceptions is met. Treas. Reg. § 1.199-3(i)(6)(iii). For a recent legal memorandum applying these two exceptions, see ILM 201226025 (Mar. 9, 2012).

Significant legislative and administrative activity surrounding the § 199 deduction has occurred since the incentive was created in 2004. Section 199 was amended by the Opportunity Zone Act of 2005 and the Tax Increase Prevention and Reconciliation Act of 2005. On May 24, 2006, the Treasury Department issued final regulations under § 199. *See* T.D. 9263. On February 15, 2008, the Treasury issued final regulations on the proper allocation of W-2 wages to domestic production gross receipts. *See* T.D. 9381. For tax years beginning after 2007, Congress amended the § 199 deduction for film and television production. Under § 199(c)(6), a qualified film for purposes of § 199 includes any copyright, trademarks, and other intangibles with respect to a qualified film produced by the taxpayer. Further, under the new law, the method and means of distributing a qualified film (e.g., online, downloaded, open air, etc.) shall not affect the availability of the § 199 deduction. I.R.C. § 199(c)(6), as amended by the Emergency Economic Stabilization Act of 2008. On March 7, 2008, the government published final regulations clarifying the definition of qualified film. T.D. 9384.

Page 349:

In 2004, Congress repealed the rules applicable to foreign personal holding companies but retained the rules applicable to controlled foreign corporations. The repeal is effective for tax years beginning after December 31, 2004.

Page 350:

Another category of foreign base income is “foreign base company sales income.” I.R.C. § 954(a)(2). Foreign base company sales income means:

Income derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where—

(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

I.R.C. § 954(d). There is an important exception to foreign base company sales income for a controlled foreign corporation that “manufactures” the products it sells. *Treas. Reg. § 1.954-3(a)(4)*. To qualify for the manufacturing exception, the property sold by the controlled foreign corporation cannot be the same property that it purchased. *Id.* § 1.954-3(a)(4)(i). The standard is

satisfied if personal property purchased by a foreign corporation is “substantially transformed” by such foreign corporation prior to sale. *Id.* § 1.954-3(a)(4)(ii). The standard is also satisfied if purchased property is used as a component part of personal property which is sold, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that “are substantial in nature and generally considered to constitute the manufacture, production, or construction of property.” *Id.* § 1.954-3(a)(4)(iii).

The exceptions described here (active rent or royalty exception, manufacturing exception) make it relatively easy to avoid subpart F of the Code, and are partly to blame for the migration of intellectual property offshore. Many U.S. companies transfer their intellectual property assets and business activities to subsidiaries in low-tax jurisdictions, such as Ireland, Switzerland, and the Netherlands, to avoid current U.S. tax on income from sales in other countries. The income earned by the controlled foreign corporation is income from the sale of property manufactured in the foreign country, and, therefore, the income is not considered subpart F income. The income will be subject to U.S. tax only if, and when, that income is repatriated to the United States (e.g., in the form of dividends to the U.S. parent corporation).

New final Treasury Regulations provide guidance for determining a U.S. shareholder’s pro rata share of a controlled foreign corporation’s subpart F income. The final regulations, for example, define pro rata share for purposes of § 951(a) and provide rules for controlled foreign corporations with one class of stock and rules for those with more than one class of stock. *See* T.D. 9222.

Page 350:

For tax years beginning after October 22, 2004, any excess credit may be carried back one year and carried forward ten years. I.R.C. § 904(c), as amended by the American Jobs Creation Act of 2004.

Page 351:

It should be noted that for tax years beginning after December 31, 2006, the American Jobs Creation Act of 2004 reduced the number of baskets (or categories) of income from eight to two, retaining only the “passive income” basket and the “general (non-passive) income” basket. I.R.C. § 904, as amended by the American Jobs Creation Act of 2004. Income in the original eight baskets is assigned to one of these two baskets as appropriate. Reducing the number of baskets from eight to two simplifies the computation of the foreign tax credit limitation. In late December 2007, the Service published final and temporary regulations to reflect the new separate categories for passive income and general (non-passive) income under § 904(d). T.D. 9368; 72 Fed. Reg. 72582-72592 (Dec. 21, 2007).

Page 353:

Sections 1441 and 1442 provide the method for collecting the 30% tax. I.R.C. § 1441 (providing that all persons in whatever capacity acting having the control, receipt, custody, disposal, or payment of the items of income specified in §§ 871 and 881 shall deduct and withhold from such items a tax equal to 30%); *id.* § 1442 (providing the general rule that in the case of foreign persons, there shall be deducted and withheld at the source in the same manner and on the same items of income as provided in § 1441 a tax equal to 30% thereof). The withholding imposed under §§ 1441 and 1442 on any payment to a foreign person may be eligible for reduction under the terms of an income tax treaty. An interesting issue is whether a U.S. person's grant to a foreign person of the right to use specified intellectual property pursuant to a cross license gives rise to income that may be subject to withholding tax. The Service recently issued Rev. Proc. 2007-23, 2007-1 C.B. 675, which allows taxpayers to use a "net consideration method" in determining withholding for a "qualified patent cross licensing arrangement."

Pages 357-358:

Section 367(d) was enacted in 1984 to prevent tax deferral—that is, to prevent U.S. taxpayers from deducting the expenses of developing intangibles in the United States and then transferring the intangibles (when they become profitable) to foreign corporations to defer tax on income produced by the intangibles. Under § 367(d), the foreign transferee corporation is deemed to make annual payments on a contingent sales contract to the U.S. transferor corporation *commensurate with the income* produced by the intangible during its useful life. This implicates the transfer pricing rules of § 482, discussed in the next section.

The American Jobs Creation Act of 2004 clarified that deemed payments arising from the transfer of intellectual property to a foreign corporation under § 367(d) are royalties for purposes of the foreign tax credit limitation discussed above. I.R.C. § 367(d), as amended by the American Jobs Creation Act of 2004.

In IRS Legal Memorandum 200610019, which involved a circular series of cross-border stock transactions, the IRS clarified that § 367(d) takes precedence over § 351(b).

Pages 358-359:

A number of high profile transfer-pricing disputes continue to arise under § 482. It was reported recently that Medtronic, Inc., a medical technology company, and the Service were litigating a transfer-pricing adjustment in Tax Court that could cost the company \$53.6 million in additional taxes. The transfer-pricing case relates to the licensing of intellectual property between Medtronic, Inc. and its wholly-owned subsidiary in Switzerland. *See* Lisa M. Nadal, *Medtronic Litigating \$53.6 Million Transfer Pricing Adjustment*, 2008 TNT 197-2 (Oct. 9,

2008). For the actual Tax Court petition, see *Medtronic, Inc. v. Commissioner*, No. 17488-08, available at 2010 TNT 150-23 (July 15, 2008). Cases such as these are likely to continue to surface as aggressive transfer pricing practices by U.S. multinationals cause significant revenue loss for the government. See Martin A. Sullivan, *Economic Analysis: Transfer Pricing Costs U.S. at Least \$28 Billion*, TAX NOTES TODAY (Mar. 22, 2010), available at 2010 TNT 54-3.

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It should be noted that a services transaction may effect a transfer of intangible property and implicate the transfer pricing rules under § 482. Proposed regulations issued in 2003 provided that a transaction structured as a services transaction may “result in a transfer, in whole or in part, of intangible property, or may have an effect similar to the transfer of intangible property, or may include an element that constitutes the transfer of intangible property.” Prop. Treas. Reg. § 1.482-9(m)(2). Under this embedded intangibles rule, what looks like income from services may be characterized as income from an intangible. After the proposed regulations were issued in 2003, the Treasury Department and the Service received substantial comments. On August 1, 2006, the Treasury and the Service issued new proposed regulations, also issued in temporary form with a delayed effective date for taxable years beginning after December 31, 2006. The 2006 temporary regulations made a number of significant changes to the 2003 proposed regulations on the treatment of controlled services transactions. For example, the 2006 temporary regulations omitted the phrase “may have an effect similar to the transfer of intangible property” because such phrase could be interpreted as improperly expanding Treas. Reg. § 1.482-4 of the existing regulations to non-intangible transactions. Temp. Treas. Reg. § 1.482-9T(m)(2). In July 2009, the Service published final regulations on the treatment of controlled services transactions that update and replace the 2006 temporary regulations. See Treas. Reg. § 1.482-9(m). Generally applicable for tax years beginning after July 31, 2009, the final regulations provide coordination rules applicable to services transactions that include elements of non-services transactions (transfer of intangibles). The final regulations rely on the “best method” rule in Treas. Reg. § 1.482-1(c)(1) to determine which method or methods would provide the most reliable measure of an arm’s-length result for a controlled transaction. See Treas. Reg. § 1.482-9(m)(1)-(2). For a good example under the temporary regulations of a controlled services transaction that includes an element constituting the transfer of an intangible, see Treas. Reg. § 1.482-9(m)(5), Example 4.

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The Service offers taxpayers, through its Advance Pricing Agreement (APA) Program, the opportunity to reach an agreement, before filing a tax return, on the appropriate transfer pricing method to be applied to related-party transactions at issue. An APA involves not only an agreement between the taxpayer and the Service, but also an agreement between the United States and one or more foreign tax authorities that the transfer-pricing method is correct to assure the taxpayer that income will not be subject to double taxation by the United States and the

foreign government. In April 2012, the IRS released a report on advance pricing agreements for calendar year 2011. Announcement 2012-13, 2012 I.R.B. 805. According to the report, 43 APAs were executed in 2011. This is only slightly fewer than the 69 APAs that were executed in 2010.

In 2005, the Service issued updated procedural rules for processing and administering APAs. *See* Rev. Proc. 2006-9, 2006-1 C.B. 278 (Dec. 19, 2005). In 2008, the Service issued Revenue Procedure 2008-31, which modifies Revenue Procedure 2006-9 by describing other issues that may be resolved through the APA program. Rev. Proc. 2008-31, 2008-23 I.R.B. 1133 (eff. June 9, 2008), modifying Rev. Proc. 2006-9. For a recent report describing the experience, structure, and activities of the APA Program during calendar year 2009, see Announcement and Report Concerning Advance Pricing Agreements (Mar. 29, 2010), *available at* Tax Analysts Doc. 2010-6857 (noting the IRS and taxpayers executed sixty-three advance pricing agreements in 2009).

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New Ownership and Developer-Assister Guidelines: On September 10, 2003, the IRS and Treasury published proposed regulations that, in part, attempted to clarify some of the difficult issues of ownership and developer-assister determinations under § 482. Prop. Treas. Reg. § 1.482-4, 68 Fed. Reg. 53447, 53447 (Sept. 10, 2003). Specifically, the 2003 proposed regulations (1) provided modified rules for determining the owner of an intangible for purposes of § 482, and (2) provided rules for determining the arm’s-length compensation in situations where a controlled party other than the owner makes contributions to the value of an intangible. On August 1, 2006, the IRS and Treasury issued new temporary regulations that, in part, provide guidance on these issues. In large part, the 2006 temporary regulations followed the 2003 proposed regulations. In July 2009, the IRS published final regulations that update and replace the 2006 temporary regulations on these issues.

Ownership of Intangible Property—Temp: The 2003 proposed regulations contained modified rules for determining the owner of intangible property for purposes of § 482. In general, the controlled party that was identified as the owner of a legal protected intangible under the intellectual property law of the relevant jurisdiction or other legal provision was treated as the owner of that intangible. Prop. Treas. Reg. § 1.482-4(f)(3)(i)(A) (2003). In other words, the “legal owner” was the sole owner for purposes of § 482 (unless legal ownership was inconsistent with the economic substance). Under the 2003 proposed regulations, if it was not possible to identify the owner of an intangible under applicable intellectual property law, contractual term, or other legal provision, the controlled taxpayer with practical *control* over the intangible would be treated as the owner. This “control standard” provision replaced the “developer-assister” standard in the prior regulations (which assigned ownership to the controlled taxpayer that bore the largest portion of the development costs). The 2006 temporary regulations made few changes to the 2003 proposed regulations with respect to ownership of an intangible for purposes of § 482. Under the 2006 temporary regulations, legal ownership was still the appropriate framework for determining ownership under § 482, with the “legal owner” being the controlled

party that possesses title to the intangible based on consideration of the facts and circumstances. Temp. Treas. Reg. § 1.482-4T(f)(3) (Aug. 1, 2006). The 2009 final regulations conclude that legal ownership is appropriate for determining ownership of intangibles, with the legal owner being the controlled party that possesses the title to the intangible based on the facts and circumstances. Treas. Reg. § 1.482-4(f)(3)(i)(A). Under the 2009 final regulations, if no owner is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms, then the controlled taxpayer that has control of intangible property, based on all the facts and circumstances, will be considered the sole owner for purposes of section 482. *Id.*

Contributions to the Value of an Intangible: The 2003 proposed regulations provided that rules for determining the ownership of an intangible should be distinct from the rules for determining the allocation of income from that intangible. They stated that the income attributable to an intangible should be allocated among controlled taxpayers under the arm's-length standard of Treas. Reg. § 1.482-1, in proportion to each party's contributions to the development and/or enhancement of the intangible and applicable ownership interests. Preamble, 68 Fed. Reg. 53449 (Sept. 10, 2003). Therefore, under the 2003 proposed regulations, allocation rules no longer turned on the ownership of the tangible property but instead relied on contributions to the value of the intangible. *Id.* This new "contributor rule" replaced the "developer-assister rule."

Under the 2003 proposed regulations, contributions to develop or enhance an intangible were governed under Treas. Reg. § 1.482-4(f)(4) and the consideration for a contribution by one controlled taxpayer to develop or enhance an intangible owned by another controlled taxpayer were determined under the applicable rules of § 482. The 2003 proposed regulations made the further distinction where controlled taxpayers "embed" compensation for a contribution in the contractual terms of a transaction involving an intangible. *See* Prop. Treas. Reg. § 1.482-4(f)(4)(i) (2003). The 2003 proposed regulations provided several examples of fact patterns involving the determination of whether consideration was "embedded" in contract terms. *See* Prop. Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 2-6 (2003). Significant controversy arose over these examples. Many commentators believed that these examples provided an increased reliance on the split-profits method of valuing transfer pricing as opposed to the comparable uncontrolled transaction method, which has been favored by the IRS and Treasury due to its adherence to the arm's-length standard. The IRS and Treasury Department agreed with commentators and modified the examples in the 2006 temporary regulations. The examples in the 2006 temporary regulations referred to application of the best method rule to intangible development costs. Temp. Treas. Reg. § 1.482-4T(4)(ii), Examples 2-6 (Aug. 1, 2006). The 2009 final regulations, effective July 31, 2009, adopt rules for determining arm's-length consideration when a controlled party other than the owner makes contributions to the value of an intangible. Treas. Reg. § 1.482-4(f)(4)(i). The 2009 final regulations provide six examples to illustrate these principles. Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 1-6.

In August 2003, the IRS and Treasury issued final regulations that provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements. *See* T.D. 9088, 68 Fed. Reg. 51171, 51171 (Aug. 26, 2003). Under the final regulations, stock-based compensation is taken into account in determining the intellectual property development costs of a controlled participant in a qualified cost sharing arrangement. *See* Treas. Reg. § 1.482-7(d)(2). Additionally, the final regulations provide two alternative methods for determining the operating expenses attributable to stock-based compensation. The default rule provides that the expenses are determined upon the exercise of the option and are measured by the spread between the option strike price and the price of the underlying stock. *See id.* § 1.482-7(d)(2)(iii)(A). Alternatively, an elective rule, allowed in certain cases, provides that expenses may be determined according to the “fair value” of the option. *See id.* § 1.482-7(d)(2)(iii)(B).

A recent transfer-pricing case involving stock-based compensation, *Xilinx, Inc. v. Commissioner*, has received considerable attention. *Xilinx v. Commissioner*, 125 T.C. 37 (2005), *rev'd*, 567 F.3d 582 (9th Cir. May 27, 2009), *aff'd*, Nos. 06-74246, 06-74269 (9th Cir. Mar. 22, 2010). Xilinx and its Irish subsidiary entered into a cost sharing agreement to develop software, agreeing to share the costs of research and development and agreeing to jointly own resulting technology. The cost sharing agreement did not address employee stock options, which Xilinx offered to its employees. Xilinx deducted the exercised options as a business expense, but the Service argued that the cost of the options should have been shared between Xilinx and its subsidiary. [Because the tax years at issue were 1996–1999, the case involved the 1995 cost sharing regulations; the 2003 amendment to the § 1.482-7 regulations clarifying that a controlled participant’s operating costs include costs attributable to stock-based compensation (discussed above) was not at issue. The 1995 cost sharing regulations, although requiring all intangible development costs to be included in the cost pool, did not affirmatively include stock-based compensation.]

The Tax Court, relying on industry practice and custom, held that participants in a qualified cost sharing arrangement were not required to share the grant-date value or the exercise spread of employee stock options. The government appealed the Tax Court’s transfer-pricing decision in *Xilinx*.

On May 27, 2009, the Ninth Circuit reversed the Tax Court, and held that related companies in a cost sharing agreement must share costs of employee stock options. 567 F.3d 582 (9th Cir. May 27, 2009). The Ninth Circuit concluded that Treas. Reg. § 1.482-7(d)(1) (requiring “all costs” related to intangible development be shared) was “irreconcilable” with Treas. Reg. § 1.482-1(b)(1) (requiring that an arm’s-length standard should apply). As the more specific provision, the former should control. According to the Ninth Circuit, Treas. Reg. § 1.482-7 (governing cost sharing agreements) is a “self-contained provision creating an exception to the general [arm’s length] methodology established in the earlier provisions. As long as taxpayers comply with the requirement of sharing all intangible development costs proportionally to the expected benefit, see Treas. Reg. § 1.482-7(b)(2) (requiring ‘each participant’s share of

intangible development costs . . . reflect that participant’s share of anticipated benefits’), they are assured the district director will not ‘make allocations’ and revise the claimed tax liability attributable to the cost sharing agreement. A bright line rule governs what costs must be shared, rather than comparing the cost sharing agreement to similar agreements between unrelated parties.”

On March 22, 2010, the Ninth Circuit withdrew its May 27, 2009 opinion in the *Xilinx* case and issued a new opinion affirming the Tax Court’s decision on employee stock option expenses in cost sharing agreements (i.e., the companies were not required to share such costs). Nos. 06-74246, 06-74269 (9th Cir. Mar. 22, 2010). In the new opinion, the Ninth Circuit rejected use of a single canon of construction (i.e., specific rule trumps a general rule), and instead examined the main purpose of the regulations, which is to achieve tax parity between taxpayers in controlled transactions and taxpayers in uncontrolled transactions. According to the court, “Xilinx would not have tax parity with unrelated parties if it were not permitted to deduct its full stock option costs.”

On July 28, 2010, the IRS issued an Action on Decision in *Xilinx*, acquiescing in the result but not the reasoning of the decision with respect to cost-sharing arrangements governed by the section 482 regulations in effect prior to their amendment. AOD 2010-03 I.R.B. 1 (Aug. 16, 2010). The IRS acquiesced in the result only “because the significance of the Ninth Circuit’s opinion is mooted by the 2003 amendments” made to the regulations. Marie Sapirie, *IRS Acquiesces in Result Only in Xilinx*, available at 2010 TNT 145-1 (July 29, 2010). The IRS, however, maintained its prior litigation position that the Ninth Circuit incorrectly held that the general statement of the arm’s-length standard in Treas. Reg. § 1.482-1(b)(1), and the specific requirement in former Treas. Reg. § 1.482-7(d) that a participant in a cost-sharing arrangement share “all the costs” of the development of the intangibles, were inconsistent. According to the IRS, the sharing of all costs, including employee stock options, under a cost-sharing arrangement complies with the arm’s-length standard. As was predicted by some, the government will likely continue to defend its position on stock options (i.e., that is consistent with the arm’s length standard). See Reuven S. Avi-Yonah, *Xilinx Revisited*, TAX NOTES 1621 (Mar. 29, 2010).

As discussed below, the IRS issued final regulations under section 482 in 2011. The IRS takes the position that these regulations resolve issues raised in *Xilinx*, i.e., *Xilinx* does not apply to cost-sharing regulations subject to the new regulations regime. See Julie Martin, *Xilinx, Veritas Don’t Apply Under Cost-Sharing Regs, IRS Official Warns*, TAX NOTES TODAY, 2012 TNT 78-9 (APR. 23, 2012) (citing *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), which determined that the IRS is entitled to Chevron deference for all regulations that have gone through a notice and comment period). There is currently a case before the Tax Court that was brought under the 2003 cost-sharing regulations involving the treatment of stock-based compensation. See Julie Martin, *Computer Chip Manufacturer Battling IRS Over Cost Sharing of Stock-Based Compensation*, TAX NOTES TODAY (July 26, 2012) (“[S]ome practitioners view Alterna’s fight as an uphill battle. Others, however, predict that if the case goes to trial, the IRS will lose for the same reasons it lost in *Xilinx*.”).

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[Insert the following new topic.]

6. 2005 Proposed Regulations and 2008 Temporary Regulations

On August 22, 2005, the Treasury Department and the IRS issued proposed revisions to the 1995 cost sharing regulations. 70 Fed. Reg. 51116-01, 2005-40 I.R.B. 625. The 2005 proposed regulations changed the conceptual framework for determining external contributions (referred to in the 1995 regulations as buy-ins), provided methods for valuing these external contributions, and included provisions to facilitate administration of, and compliance with, the cost sharing rules. Many advisors argued that the 2005 proposed regulations' sweeping changes substantially reduced the attractiveness of cost sharing arrangements. See Robert Goulder, *Cost-Sharing Regulations May Cost U.S. Jobs, Witnesses Say*, TAX NOTES, at 1628 (Dec. 26, 2005); Keith Reams et al., *Proposed Cost-Sharing Regulations: Are They a Realistic Alternative?*, 109 TAX NOTES 239 (Oct. 10, 2005).

On December 31, 2008, the Treasury Department and the IRS released revised proposed and temporary regulations on cost sharing arrangements, making significant changes to the 2005 proposed regulations. T.D. 9441, 2009-7 I.R.B. 460, 74 Fed. Reg. 340-391 (Jan. 5, 2009). The 2008 temporary regulations, which replaced the 2005 proposed regulations, retained the "investor model" and introduced added flexibility in designing cost sharing arrangements. In December 2011, the IRS issued final regulations under section 482 on determining taxable income from cost-sharing arrangements. T.D. 9568, 2012-12 I.R.B. 499. The 2011 final regulations adopt, with several changes, the 2008 temporary regulations. Specifically, the 2011 final regulations adopt the investor model of the 2008 temporary regulations as well as the government's preference for aggregate valuation of intangibles.

For a summary of the 2005 proposed regulations, the 2008 temporary regulations, and the 2011 final regulations, see JEFFREY A. MAINE & XUAN-THAO N. NGUYEN, *INTELLECTUAL PROPERTY TAXATION: TRANSACTION AND LITIGATION ISSUES* Ch. 9 (BNA Books 2004, 2012 Cumulative Supplement).

On December 10, 2009, the Tax Court released its taxpayer-favorable decision in *Veritas Software Corp. v. Commissioner*, 140 T.C. No. 14 (Dec. 10, 2009), a high-profile case of first impression regarding a buy-in payment. Veritas, a software developer and manufacturer, entered into a cost-sharing arrangement in 1999 with its foreign subsidiary to develop and manufacture storage-management software products. Pursuant to the cost-sharing arrangement, the foreign subsidiary was granted rights to use certain preexisting intangibles. As consideration for the transfer of preexisting intangibles, the subsidiary made a lump sum buy in payment of \$166 million to Veritas, using the comparable uncontrolled-transaction method to calculate the payment. The IRS, using an income method, allocated \$1.68 billion for the lump sum payment.

Veritas argued that the IRS's determinations were arbitrary, capricious, and unreasonable and that the comparable uncontrolled transaction method was the best method to calculate the buy-in payment. The Tax Court held for Veritas, finding that the IRS's determination was arbitrary, capricious, and unreasonable. The Tax Court concluded that Veritas's comparable uncontrolled transaction method, with appropriate adjustments (e.g., adjustments to royalty rates), should be used for determining the buy-in payment. It was consistent with the arm's-length method and the best available method for determining the requisite buy-in amount under the cost-sharing arrangement. The *Veritas* decision is significant for many U.S. companies that have entered cost-sharing arrangements involving buy-in payments for preexisting intangibles under the 1995 cost-sharing regulations.

It should be noted that the IRS, rather than appeal, issued an Action on Decision, in the *Veritas* transfer pricing case. AOD 2010-05 (Dec. 6, 2010). In the Action on Decision, the IRS stated that it does not acquiesce in the result or reasoning of the *Veritas* opinion. The IRS's non-acquiescence in *Veritas* signals that it will continue to litigate its position—"will continue to apply an aggregate valuation to interrelated transactions related to a CSA where, under the facts and circumstances, such valuation provides the most reliable measure of an arm's-length result." *Id.* [It should be noted that the Tax Court's decision in *Veritas* involved pre-2009 regulations. As noted above, the IRS issued temporary cost-sharing regulations on January 5, 2009, that prescribe the income method as a specific method and "arguably provide stronger rules permitting the IRS to aggregate transactions." Cindy Hustad, Jennifer Seymour & Alan Shapiro, *IRS Decides Not to Appeal Veritas; Action on Decision Issued*, available at 2010 TNT 243-6 (Dec. 20, 2010). The Tax Court's decision in *Veritas* has no direct bearing on those regulations, and applies to taxpayers who made buy-in payments subject to the pre-2009 regulations. While practitioners and the government debate the meaning and potential effects of the Tax Court's decision, one message is clear from the IRS's non-acquiescence in *Veritas*: Cost-sharing arrangements remain a top priority for IRS examination. See David D. Steward, *Cost-Sharing Arrangements Remain a Top Priority on Examination, IRS Official Says*, available at 2010 TNT 237-4 (Dec. 10, 2010).

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The Internet Tax Freedom Act (ITFA) was enacted in 1998. Pub. L. No. 105-277. It imposed a temporary moratorium on new taxes imposed by states and local government entities on Internet access services, and multiple or discriminatory taxes on electronic commerce transactions. Since ITFA expired on October 21, 2001, Congress has temporarily renewed the moratorium several times. In 2001, Congress enacted the Internet Tax Nondiscrimination Act (ITNA), which extended ITFA until November 1, 2003. On December 3, 2004, Congress again extended the moratorium on Internet taxes for four years, retroactively one year to November 1, 2003, and forward three years until November 1, 2007. Pub. L. No. 108-435.

ITNA defines "tax on Internet access" as a tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access, and regardless

of the terminology used to describe the tax. The definition for “tax on Internet access” does not include a tax levied upon or measured by net income, capital stock, net worth, or property value. The term “Internet access” does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access. ITNA also includes a “State Telecommunications Service Tax” provision. ITNA provides a moratorium of state telecommunication service taxes until November 1, 2006. “State Telecommunications Service Tax” means a state tax that was enacted by state law on or after October 1, 1991, imposed on telecommunications service, and applied to Internet access through administrative code or regulation issued on or after December 1, 2002. With respect to accounting for Internet access and telecommunications taxes, ITNA provides that if the charges for Internet access are aggregated with, and not separately stated from, charges for telecommunications services or other charges that are subject to taxation, then the charges for Internet access may be subject to taxation. Such charges for Internet access are permitted unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business.

ITNA was scheduled to sunset on November 1, 2007. On October 31, 2007, President Bush signed into law the Internet Tax Freedom Act Amendments Act of 2007, which extended the moratorium on new taxes on Internet access, and multiple and discriminatory taxes until November 1, 2014. Pub. L. No. 110-108. Under this legislation, the term “Internet access” includes “a homepage, electronic mail and instant messaging (including voice-and video-capable electronic mail and instant messaging), video clips, and personal electronic storage capacity, that are provided independently or not packaged with Internet access.

The 2007 amendments provide some exceptions. Effective November 1, 2007, the moratorium does not apply to state taxes “expressly levied on commercial activity, modified gross receipts, taxable margin, or gross income of the business, by a State law specifically using one of the foregoing terms.” Also, the moratorium does not apply to a tax that is “not discriminatory in its application to providers of communication services, Internet access, or telecommunications.”

[NOTE: It should be noted that ITNA does not exempt Internet transactions from taxation; it merely provides a temporary moratorium on new state and local taxes on Internet access, and multiple or discriminatory taxes on e-commerce. Thus, sales and use taxes may still apply to sales of taxable items over the Internet. Further, ITNA does not prevent states and local governments from imposing use tax collection on remote vendors; rather, the *Quill* decision does that. But, as the materials in the chapter demonstrate, some state court decisions have found a way around *Quill*. There is ongoing debate over whether ITNA should sunset, be temporarily extended, or should be made permanent.]

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4. *Tax Decisions Interpreting ITFA [New Topic]*

Since the enactment of ITFA, there have been very few challenges brought by Internet vendors on the validity of a state tax statute in light of ITFA. For a recent ruling that a state tax was not in violation of ITFA, see Washington Department of Revenue, Det. No. 05-0006E, 24 WTD 309 (2005), available at <http://dor.wa.gov/content/laws/> (determining that a Washington tobacco products tax was not a tax on internet access and did not impose multiple or discriminatory taxes on electronic commerce).

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Read carefully *Borders Online, LLC v. State Board of Equalization*, 29 Cal. Rptr.3d 176 (2005), and *St. Tammy Parish Tax Collector v. Barnesandnoble.com*, 481 F.Supp.2d 575 (E.D. La. 2007), two recent cases which are included below. Can you reconcile the two decisions? Note that *St. Tammy Parish Tax Collector v. Barnesandnoble.com* is the first case in which a federal court addressed the issue of whether a substantial nexus exists between a taxing jurisdiction and an out-of-state Internet company.

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Insert the following two cases after the *Quill* excerpt:

Borders Online, LLC v. State Bd. of Equalization
Court of Appeal of California, First Appellate District, Division Four
29 Cal. Rptr. 3d 176 (2005)

RIVERA, JUDGE:

We face with increasing frequency issues at the junction of Internet technology and constitutional principles. This is another such case.

Borders Online, LLC (Online), a Delaware company, sold more than \$1.5 million in merchandise over the Internet to California consumers in 1998 and 1999. Online is a limited liability corporation formed under Delaware law in 2001 with headquarters in Michigan. Online was wholly owned by Borders Group, Inc. Borders Group, Inc., also owns Borders, which, in turn, owns Borders stores.

From April 1998 to September 1999, Online sold books, book accessories, magazines, compact discs, videotapes, and similar tangible goods over the Internet to customers, including customers in California. It did not own or lease property in California during the disputed period and did not have any employees or bank accounts in the state. Online employees located outside California received and processed all orders placed through Online's website, Borders.com. Online neither collected tax from its California purchasers nor paid sales or use taxes to the Board for its sales to California purchasers during the disputed period.

Online's website included a notice that any goods purchased from Online could be returned to any Borders Books and Music store (Borders store). Under the policy of Borders, Inc. (the owner of Borders stores), customers could exchange the items or receive a credit card refund. Numerous Borders stores are located all over California.

Borders, Inc. (Borders) and Online also engaged in incidental cross-marketing practices to benefit the Borders brand. Online and Borders are affiliated through a common parent company but are distinct corporate entities.

Numerous Borders stores are located throughout California and in other states. Borders stores sell merchandise that is comparable to the goods sold by Online over the Internet. Receipts at Borders stores sometimes contained the phrase "Visit us online at www.Borders.com." Although Borders stores did not have facilities to assist customers wishing to place orders with Online, Borders's employees were encouraged to refer customers to Online. Visitors to Online's website could access a "link" to Borders's website, www.bordersstores.com, which provided advertising and promotional information for Borders stores, including a list of store locations.

On November 5, 2001, the State Board of Equalization (Board) issued a notice of redetermination to Online for unpaid use taxes, plus interest (but not penalties) for the company's sales to California purchasers. After exhausting its administrative remedies, Online filed a complaint in San Francisco Superior Court seeking a refund. The court held that (1) Online was covered by section 6203(c)(2) because of Online's policy providing for returns at Borders stores, (2) the imposition of a tax on Online did not violate the commerce clause, and (3) the fact that Online's return policy was not posted on its website during the entire disputed period did not affect the conclusion that Online had a sufficient physical presence in California to support a finding of "substantial nexus." The trial court entered judgment on November 26, 2003, and Online timely appealed.

B. Online Is Subject to California's Use Tax

A use tax on interstate sales is a tax on the privilege of use of property by the buyer who purchases goods that would not otherwise be subject to a sales tax. California imposes a use tax "on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer ... for storage, use, or other consumption in this state..." (§ 6201.) The tax is paid by the purchaser but is collected by the retailer. (§§ 6202, subd. (a), 6203, subd. (a).) A retailer that fails to collect the appropriate use taxes becomes indebted to the state for the amount owed. Both parties agree this case is governed by section 6203(c)(2) (defining "[r]etailer engaged in business in this state"), but disagree as to whether the statute applies to Online. The question, then, is whether Online had a "representative" or "agent" in California acting under the authority of Online for the purpose of "selling" personal property.

1. Borders Acted Under Online's Authority As Its Agent

Online claims the trial court erred in ruling as a matter of law that Borders was Online's agent because issues of agency typically are questions of fact. It is true that the existence of an agency relationship is usually a question of fact, *unless the evidence is susceptible of but a single inference*. Here, the undisputed evidence is susceptible of but one inference—that Borders was acting as Online's authorized agent or representative. A representative is "[o]ne who stands for or acts on behalf of another." Black's Law Dict. (7th ed.1999). "An agent is one who represents another, called the principal, in dealings with third persons." Civ.Code, § 2295. An agency relationship may be implied based on conduct and circumstances. There is no dispute either that Online announced on its website that Borders was authorized to accept Online's merchandise for return, or that Borders would provide customers with an exchange, store credit, or a credit card credit. By accepting Online's merchandise for return, Borders acted on behalf of Online as its agent or representative in California.

2. Borders Was "[S]elling" for Purposes of Section 6203(c)(2)

The trial court concluded that by providing refunds and exchanges to Online's customers pursuant to Online's return policy, Borders was engaged in "selling" as that term is used in section 6203(c)(2). The court reasoned that the term "selling" may properly be defined to include all activities that constitute an integral part of inducing sales. Such a definition fairly captures the common understanding of this term. The term "selling" is not defined in the statute. The Board construed the term to include all activities that are an integral part of making sales, and concluded that this interpretation accords with its common usage. The Board reasoned, "When out-of-state retailers that make offers of sale to potential customers in California authorize in-state representatives to take

returns, these retailers acknowledge that the taking of returns is an integral part of their selling efforts. Such an acknowledgement comports with common sense because the provision of convenient and trustworthy return procedures can be crucial to an out-of-state retailer's ability to make sales. This is especially evident in the realm of e-commerce." Online, by contrast, proposes the term "selling" be narrowly defined as "the act of making a sales transaction."

We think the Board's interpretation of the term "selling" is persuasive. The Board appears to have thoroughly considered the meaning of the term, and its reasoning that the act of "selling" encompasses offering other inducements to purchase is consistent with at least one later pronouncement. Our analysis is reinforced by the fact that Online's return policy contemplates that "sales" may take place pursuant to the policy. The Legislature has defined "sale" for purposes of the state's use tax as including "any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration." (§ 6006, subd. (a).) Borders was authorized to provide Online's customers with store credit that could be used for the future purchase of Borders merchandise. Borders also would exchange Online's merchandise for its own merchandise. Either transaction certainly falls within the Legislature's definition of "sale" under section 6006, subdivision (a). When considered in tandem with other cross-selling techniques, such as Borders's employees referring customers to Online and Borders's receipts printed with the message "Visit us online at www.Borders.com," the Board's conclusion that Borders was Online's representative "for the purpose of selling" Online's goods is a correct application of the law.

C. *The Trial Court's Ruling Is Consistent with the Commerce Clause*

It is well settled that under the commerce clause, there must be a sufficient connection between a state and a retailer in order for the state to impose a use tax on the seller's goods. This nexus prevents states from otherwise imposing impermissible burdens on interstate commerce. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 312-313 (1992). A tax passes constitutional muster only if it is applied to an activity with a substantial nexus with the taxing State.

In *Quill*, the United States Supreme Court reversed an opinion of the North Dakota Supreme Court that permitted a tax on a mail-order business with no physical presence in the state. Confirming the "bright-line" rule articulated in *Bellas Hess* the *Quill* court held that a use tax is impermissible where a seller's only connection with a particular state is orders placed and merchandise delivered through a common carrier or the United States mail; a seller must have a physical presence in a state to satisfy the commerce clause. As the United States Supreme Court has observed, "the crucial factor governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales." *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 250 (1987). Online does not dispute it established and maintained a robust market for sales in California. The question is whether the record satisfies the remainder of the test, i.e., that the activities performed by Borders on its behalf were "significantly associated with [Online's] ability to establish and maintain" its California market. We conclude that they were.

As an initial matter, we address Online's position that a state has no authority to impose a tax collection duty on an out-of-state retailer unless its in-state representative is "*actually making sales transactions*." The pivotal question when testing a state's taxing authority against the dormant commerce clause is not whether the foreign company has agents soliciting sales in the state. The question, rather, is whether the activities of the retailer's in-state representatives are "significantly associated with [its] ability to establish and maintain a market in [the] state for the sales." While the cases assess a combination of activities that often include solicitation or sales, the analysis turns on the totality of the activities undertaken to maintain a successful market.

We have already determined that Online's return policy was part of its strategy to build a market in California. We further note that Borders's efforts on Online's behalf were not limited to accepting returns from—and providing exchanges and credit card refunds to—Online customers. Borders's receipts were sometimes imprinted with "Visit us online at www.Borders.com," and Borders's employees were encouraged to refer customers to Online to find merchandise not available at Borders stores. The cross-selling synergy was also maintained by the use of

similar logos, by the link to Borders' website from Online's website, and by the sharing of some market and financial data between the two entities. Online generated more than \$1.5 million in sales in California in 18 months. These facts amply support the conclusion that Online had a representative with a physical presence in the State and the representative's activities were significantly associated with Online's ability to establish and maintain a market in the state for the sales.

Online also contends that the Board must present evidence that quantifies the activities actually undertaken by Borders on behalf of Online establishing that those activities had more than a de minimis effect on Online's sales. While it is true that substantial nexus will be measured by the "extent and nature of the contacts between the state and the foreign corporation," *Illinois Commercial Men's Assn. v. State Bd. of Equalization*, 671 P.2d 349 (1983), Online has cited no case, and we have found none, that requires this to be quantified in the first instance by the taxing agency. Indeed, the authorities are virtually unanimous that one who claims an exemption from taxation has the burden of proving it. The retailer has the burden of proving facts establishing his right to exemption. The rule is a reasonable one since the taxpayer is in the best position to create and maintain records of his transactions and to destroy or conceal such records.

Here, Borders did not keep records of the returns from Online customers, and presumably, also did not record each instance in which an employee referred a customer to Online, nor keep track of how many receipts were imprinted with "Visit us online at www.Borders.com." Accordingly, we cannot see how such evidence would even be assembled. We do agree that evidence of de minimis local activities or proof that the local activities do not generate any significant proportion of local sales would create an issue of fact that would have to be resolved at trial. No such evidence was introduced by Online, other than a declaration by Borders's former tax manager that Borders "expected" only a small amount of returns.

Our holding is not affected by the fact Online's return policy was not posted on its website during the entire disputed period. We conclude that the fact Online's return policy was posted for less than 11 months during the 18-month disputed period does not alter the constitutional analysis. As Online itself notes, the question for purposes of the commerce clause is the "nature and extent" of the activities in the taxing state. Here, Borders stood ready to accept returns and issue refunds for all Online merchandise purchased in California, whether or not this policy was actually posted on Online's website. All the while, Borders and Online were involved in cross-promotional activities, promoting the Borders "brand." Were we to accept Online's argument that a substantial nexus did not exist during the entire time period, the company would be free to simply promote the policy through its in-state agent and reap the benefits of that policy while avoiding the state's use tax by promoting—and then simply removing—the policy on its website.

In short, we conclude that the imposition of a use tax on Online during the entire disputed period does not violate the commerce clause of the United States Constitution.

The judgment is affirmed.

St. Tammany Parish Tax Collector v. Barnesandnoble.com
Federal District Court, Eastern District of Louisiana
481 F. Supp. 2d 575 (E.D. La. 2007)

VANCE, District Judge.

This is an action for collection of sales and use taxes under Louisiana law. The parties have agreed to submit the case to the Court for decision on the stipulated record. For the following reasons, the Court FINDS for the DEFENDANT.

I. BACKGROUND

Defendant barnesandnoble.com, LLC (“Online”) is an internet retailer of books, movies, and music at the internet address www.barnesandnoble.com. The company accepts orders from customers across the country, including in St. Tammany Parish, and fills these orders through a national distribution system that has no physical presence in Louisiana except for the use of common carriers to deliver merchandise from out-of-state that was ordered online. During the period in question in this case, January 2001 through December 31, 2005, the company did not maintain a mailing address or telephone number in the State of Louisiana. It had no employees in Louisiana and owned no tangible property in the State.

From January 2001 through October 2003, Barnes & Noble, Inc. owned 40% of Online. Between October 2003 and May 2004, Barnes & Noble, Inc. owned 80% of Online through a wholly-owned subsidiary. Between May 2004 and December 31, 2005, Barnes & Noble, Inc. owned 100% of Online through a wholly-owned subsidiary, B & N Holding Corp.

During the period at issue, Barnes & Noble, Inc. also wholly owned Barnes & Noble Booksellers, Inc. (“Booksellers”). Booksellers owned and operated retail stores throughout the country, including one in St. Tammany Parish, under the brand name “Barnes and Noble.” The Booksellers retail outlet in St. Tammany Parish was located in the City of Mandeville. Although the two companies were both owned, in whole or in part, by the same parent corporation, Booksellers and Online did not share management, employees, offices, and other important elements of their businesses.

On October 31, 2005, the St. Tammany Parish Tax Collector sued defendants in Louisiana state court on behalf of various taxing jurisdictions within the Parish for sales and use taxes that Online allegedly failed to collect during the tax period. On November 16, 2005, defendants removed the case to this Court. The parties cross-moved for summary judgment, and on January 17, 2007, the Court held oral argument on the issues raised in the cross-motions. At the hearing, the parties agreed to submit the issue for trial on the briefs and the stipulated record.

II. LEGAL STANDARD

The parties have agreed to convert their motions for summary judgment into a trial on the briefs and the stipulated record. The Court therefore uses the legal standard applicable at trial, not the summary judgment standard. Plaintiff therefore bears the burden of proof by a preponderance of the evidence.

III. DISCUSSION

A. Substantial Nexus

Before it may impose a tax on an out-of-state entity, a state or local jurisdiction must establish that the imposition of the tax is consistent with the Commerce Clause of the Constitution. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992). The state must show that the “tax [1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.” This case involves only the first of these requirements.

In *Quill*, the Supreme Court reversed a state court's ruling that upheld the imposition of sales and use taxes on a mail-order business without a physical presence in the state. Employing the “substantial nexus” test, the Court inquired whether the vendor had enough contacts with the taxing state to justify the state's interference with interstate commerce. The Court held that “a vendor whose only contacts with the taxing State are by mail or common carrier lacks the ‘substantial nexus’ required by the Commerce Clause.” *See also Nat’l Bellas Hess, Inc. v. Dept of Revenue of State of Ill.*, 386 U.S. 753 (1967), overruled in part and on other grounds by *Quill*, 504 U.S. 298. The Court noted that the test draws a “sharp distinction ... between mail-order sellers with [a physical presence in the taxing] State and those ... who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business.” Although it acknowledged that the ability to “tax may turn on the

presence in the taxing state of a small sales force, plant, or office,” the Court noted that the existence of a bright-line rule in this area of the law provides benefits that outweigh the seeming “artificiality” of the rule. The Court in *Quill* specifically reaffirmed the bright-line, physical presence rule first enunciated in *Bellas Hess*. The Court also stated that advertising in national publications and licensing company-owned software to in-state clients was insufficient to create the requisite nexus. The Court noted that it rejected a “slightest presence” standard for constitutional nexus.

The Supreme Court in *Quill* also discussed a separate substantial nexus test derived from the Due Process clause of the Fifth and Fourteenth Amendments. That test asks whether the company at which the tax is aimed has purposefully directed its activities at the forum jurisdiction, whether the magnitude of its contacts meet a minimum standard to justify jurisdiction, and whether the tax is related to the benefits received from the state or jurisdiction. As the Court indicated in *Quill*, a tax can satisfy the Due Process Clause test but fail the Commerce Clause test. Because the Court finds that Online did not have a substantial nexus with the Parish for purposes of satisfying the dormant Commerce Clause, the Court does not reach the issue of whether the imposition of a sales and use tax collection requirement on Online during the taxing period would also violate Due Process.

In another set of cases, the Supreme Court articulated an attributional nexus test. In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Supreme Court held that a company may not avoid a sufficient nexus merely by classifying the parties that constitute the company's physical presence in the taxing jurisdiction as independent contractors. *Scripto* involved an Atlanta company engaged in selling mechanical writing instruments. The company contracted with ten advertising specialty brokers to solicit sales within the State of Florida. The Court held that the physical presence of the brokers, who were actively soliciting on behalf of the company, constituted sufficient nexus for purposes of a use tax collection requirement. The Court was concerned that allowing the constitutionality of imposing a tax to turn on the formal classification of the parties in a contract “would open the gates to a stampede of tax avoidance.” The Court reaffirmed this principle in *Tyler Pipe Industries, Inc. v. Wash. State Dept. of Revenue*, 483 U.S. 232, 250 (1987), holding that the applicability of tax requirements hinged on “whether the activities performed in [the taxing jurisdiction] on behalf of the taxpayer [were] significantly associated with the taxpayer's ability to establish and maintain a market ... for the sales.” In that case, the out-of-state company's in-state sales representatives, working for an independent contractor, were the primary conduit between the company and its customers and potential customers in the State of Washington. As such, the activities of the independent contractor on behalf of the out-of-state company were enough to create a substantial nexus. Attributional nexus thus arises when the presence of a person or entity in the taxing jurisdiction is attributed to another entity for purposes of establishing nexus. The Parish argues that the physical presence of Booksellers' store in Mandeville should be attributed to Online because Booksellers allegedly acted on Online's behalf within the taxing jurisdiction.

Specifically, the Parish cites five aspects of the business relationship between Online and Booksellers as evidence that a substantial nexus existed during the relevant period:

- (1) The companies offered a membership program in which customers paid an annual fee and received discounts on merchandise purchased from either company, and Online derived revenue from the annual fees.
- (2) Booksellers sold gift cards that were redeemable with Online and included Online's web address.
- (3) Online received commissions on merchandise ordered at Booksellers retail stores but shipped directly to the customer.
- (4) The two companies engaged in advertising on behalf of each other.
- (5) Booksellers stores gave preferential treatment to returns of merchandise purchased from Online.

According to plaintiff, these five characteristics of the companies' relationship establish a substantial nexus between Booksellers and Online. The Court describes each of these factors separately.

1. The Membership Program

During the period in question, Online, Booksellers, and several other retailers participated in a customer loyalty program run by Barnes & Noble, Inc., the companies' parent corporation. Under the program, customers purchased \$25 memberships that entitled them to discounts and other special offers from participating retailers. The proceeds from the membership fees were distributed by Barnes & Noble, Inc. among the participating companies on a pro rata basis according to the percentage of overall discounts under the program awarded by each company. Thus, Online did not receive revenue from sales made by Booksellers, and Booksellers did not receive revenue from sales made by Online. Further, neither company made sales or took orders for the other.

Both Booksellers and Online advertised and marketed the membership program within their respective arenas. This included advertising the availability of discounts from the other participants in the program. In addition, the participants in the program shared all member names and e-mail addresses, which were used for direct marketing.

2. Gift Cards

Online participated in a multi-retailer gift card program with several other retailers, including Booksellers. In most relevant respects, the gift card program mirrored that of the membership program. Gift cards were available and redeemable at Booksellers stores and at Online's website, as well as at other participating retailers. The promotional materials used by program participants, including Booksellers' Mandeville store, advertised that gift cards were redeemable at Online's website.

Marketing Services (Minnesota) Corp., Inc. ("MSMC") administered the gift card program. During the tax period, MSMC was a subsidiary of Barnes & Noble, Inc., and was located outside Louisiana. Under the program, a participating company remitted the proceeds from the sale of a gift card to MSMC in return for a fee. Upon redemption of the card, MSMC would pay the retailer the face value of the card. Thus, a participating retailer would interact only with MSMC and the customer in fulfilling its obligations under the program. The retailer would receive revenue only upon sending the proceeds from the sale of a card to MSMC or upon use of the card to purchase merchandise from that retailer. As with the membership program, a participating retailer derived revenue only from selling gift cards directly to customers or from accepting gift cards as payment for items purchased from that retailer. Participants therefore did not derive revenue from sales made by other participating retailers.

3. Commissions on In-Store Sales

During the tax period, when a Booksellers store did not carry an item requested by a customer, the customer could place an order with a clerk and have the item shipped to the store for pickup or directly to the customer. The store would "source" the item through a computer system that found the item among various wholesalers and distribution centers, including Booksellers' own warehouses and those of third-parties. Booksellers' stores were not able to choose a particular source through the system, but the computer would determine the source in accordance with predetermined criteria such as price and proximity. In some cases, the system sourced the order to Online's distribution centers, which shipped the item directly to the customer or to the Booksellers store. Online charged Booksellers a wholesale price plus a commission for the purchase, and Booksellers would resell the item to the customer. In filling these orders, Booksellers would collect any applicable state and local sales taxes.

4. Cross-Promotional Advertising

The taxing authority relies on certain activity by Online that promoted Booksellers' stores. Online's website provided a "store locator" to identify nearby locations. The website also provided information about events taking place at Booksellers retail stores, including the Mandeville store. The only evidence that Booksellers promoted Online during the tax period was in connection with their activities in advertising the multi-retailer gift and membership programs discussed, *supra*. As the manager of the Mandeville store testified, store employees would provide information about the website only if asked by a customer.

5. Returns

During the tax period, Booksellers stores accepted returns of merchandise carried by Booksellers stores regardless of where the merchandise was purchased. Customers who had purchased items from Online could return an item and, upon showing a receipt, receive store credit from Booksellers for the amount paid to Online for the item. Online advertised this aspect of Booksellers' return policy on its own website. Customers who did not show a receipt-in effect, customers who could have purchased the item from any retailer-received store credit in the amount of the price of the item at that time in Booksellers' store. Booksellers accepted returns from other bookstores to encourage customer satisfaction, entice new customers, and as a source of income. The manager of the Mandeville store testified that the decision as to whether to give a full refund to a customer who presented a receipt from a retailer other than Booksellers or Online, was within the discretion of the store manager. She stated that customers did not typically bring in receipts from competing retailers, such as Books-a-Million, but that she would have given a full refund to customers who did so in order to satisfy the customer.

B. Nexus Analysis

Considering the relationship between Booksellers and Online, the Court concludes that Online did not have a substantial nexus with the Parish. The activities of Booksellers in St. Tammany Parish on behalf of Online were not of the order of magnitude necessary to establish that Booksellers marketed Online's products on Online's behalf in the Parish. The existence of a close corporate relationship between companies and a common corporate name does not mean that the physical presence of one is imputed to the other. *See, e.g.*, *SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220, 585 A.2d 666 (1991) (refusing to impute nexus from bricks-and-mortar retailer to mail-order retailer when the retailers were separate corporate entities owned by the same parent company, sharing some directors and officers, using the same trademarks and logos, selling similar merchandise, and sharing financial and market information); *Bloomington's By Mail, Ltd. v. Pennsylvania*, 130 Pa.Cmwlth 190, 567 A.2d 773 (1989) (holding that affiliation alone was insufficient to create nexus); *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St.3d 119, 652 N.E.2d 693 (1995) (rejecting unitary business entity argument that would impute nexus to affiliated, out-of-state retailer); *Current, Inc. v. State Board of Equalization*, 24 Cal.App.4th 382, 391, 29 Cal.Rptr.2d 407 (Cal.App. 1 Dist.1994) (holding that nexus could not be imputed between companies that did not have integrated operations or management and were organized as separate and distinct entities). Booksellers and Online were formally separate corporate entities that were wholly owned by the same parent company for only part of the period in issue. The two companies clearly shared a common name and brand identity under the "Barnes & Noble" banner, but there was no overlap between the companies' management or directors. There is no allegation that the companies intermingled assets or that they were under financed. And to the extent the companies may have shared financial or market data, that fact is not of independent significance. The companies did not hold themselves out as the same entity. Thus, the Court finds that attributional nexus does not apply merely by virtue of the affiliation between the companies.

Further, the nature and extent of the activities performed by Booksellers on behalf of Online within St. Tammany Parish were insufficient to treat Booksellers as acting as a marketing presence for Online in the Parish. In *Tyler Pipe* and *Scripto*, the Supreme Court was concerned that companies could avoid tax obligations merely by reclassifying employees, such as salespeople, as independent contractors. In both cases, the out-of-state concerns had in-state sales representatives acting continuously on their behalf to solicit orders for sales to customers. Further, *Quill* established that the Court has not adopted a "slightest presence" standard so that a de minimis amount of property in the taxing jurisdiction does not suffice to establish the requisite nexus. Booksellers' activities were not tantamount to acting as a sales presence for Online. Booksellers has never taken or solicited orders on behalf of Online and did not provide facilities to place orders with Online. The absence of such activity by the in-state affiliate was significant in cases finding no nexus. Further, the Parish has not demonstrated that participation in the gift card and membership programs, in which the revenue is divided on a pro-rata basis among all participating retailers, can constitute the sufficient nexus upon which to base tax liability. Neither of these programs produces revenue to Online by virtue of sales made or orders taken by the entity that is physically present in the Parish. That Online may have derived a benefit from Booksellers' advertising of the program is not sufficient to impute its presence to

Online. For example, in both *SFA Folio Collections v. Bannon* and *SFA Folio Collections v. Tracy*, the mail-order retailers distributed their catalogs to the local stores for distribution to customers or for use in marketing. This sort of advertising creates a stronger case for nexus than the existence of promotional materials for a joint-discount or gift card program that mention the other participating retailers. Nevertheless, in the cited cases, this activity was insufficient to create the requisite nexus. In addition, although the Parish argues that Online receives commissions from in-store sales, it is clear from the evidence that Online in fact is one of many wholesalers, including its competitors, from whom Booksellers sources items that it does not have in stock, to be shipped to the store or directly to the customer. There is no evidence that Booksellers treats Online any differently from other third-party wholesalers in its system. Further, the evidence shows that Booksellers treats this type of sale as its own sale and collects any applicable taxes. In fact, Booksellers stores cannot even choose the source of these items, but instead relies on a computer system.

The final factor cited by the Parish is Booksellers' return policy. Booksellers' return policy was preferential to Online in that Booksellers accepted Online's merchandise as if it were its own, whereas with other retailers, Booksellers' policy was to give store credit in the amount of the price of the item in Booksellers' store at that time, although the local manager had discretion to give full refunds if customers presented receipts from other retailers. Online advertised this benefit on its website. Both the *SFA Folio Collections v. Tracy* and *Bloomingtondale's By Mail v. Pennsylvania* courts rejected the argument that a preferential return policy established substantial nexus. This Court agrees with the decisions of the Ohio and Pennsylvania courts in these cases. The policy of Booksellers to accept returns according a slightly more generous policy than the one extended to other retailers is not comparable to an independent contractor making sales on behalf of the out-of-state retailer, such as was involved in *Scripto and Tyler Pipe*. Nor is it comparable to the level of sales or sales support activity undertaken by in-state agents in other cases in which courts have found nexus. *See, e.g.*, *In re Scholastic Book Clubs, Inc.*, 260 Kan. 528, 920 P.2d 947 (1996) (finding nexus when out-of-state retailer effectively used Kansas teachers to sell books to Kansas students); *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal.App.3d 734, 255 Cal.Rptr. 77 (finding nexus on facts similar to Kansas case); *State v. Dell Int'l, Inc.*, 922 So.2d 1257, 1263-1266 (La.App. 1st Cir.2006) (imputing nexus to foreign computer retailer based on agreements with in-state technical service provider under which service provider provided computer support services on the foreign retailer's behalf and at its direction, and those services were crucial to the retailer's ability to sell its products); *Reader's Digest Ass'n v. Mahin*, 44 Ill.2d 354, 357-59, 255 N.E.2d 458 (Ill.1970) (imputing nexus to parent corporation because of its local advertising and solicitation for advertisements in-state by its wholly-owned subsidiary). Further, Booksellers initiated the return policy to generate goodwill and to serve the convenience of its customers. The only case to rely on a comparable return policy to find nexus implied that a policy based on such considerations would not be indicative of the requisite nexus. *Borders Online v. State Board of Equalization*, 129 Cal.App.4th 1179, 1199, 29 Cal.Rptr.3d 176 (Cal.App. 1 Dist.2005).

Accordingly, considering all of the evidence adduced by the Parish in support of its contention, the Court finds that a substantial nexus does not exist upon which to base tax liability.

IV. CONCLUSION

For the reasons stated above, the Court FINDS for the DEFENDANT.