June 2015 Student Update Memorandum for

Maine & Nguyen's

Intellectual Property Taxation: Problems and Materials

(2nd ed. 2015)

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CAROLINA ACADEMIC PRESS
Durham, North Carolina

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www.cap-press.com

Chapter 2
Overview of Intellectual Property

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

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

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

Chapter 3
Overview of Traditional Principles of Federal Income Taxation

Page 60: In 2015, the AMT 28% rate begins at $185,400. For 2015, the exemption amounts are $53,600 for unmarried individuals and $83,400 for joint filers. Rev. Proc. 2014-61. These exemptions are phased out for high income taxpayers.

Chapter 4
Taxation of Intellectual Property Development

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

Page 81: Tax cases involving book writing activities are not always easy to reconcile. *See* Ballard-Bey v. Commissioner, T.C. Summ Op. 2014-62 (concluding that although the taxpayer undertook his book writing activity with the honest intent to generate a profit, his profit-seeking activity was not functioning as a going concern in the years at issue).

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

- The ultimate success, failure, sale, or other use of the research or property resulting from research is not relevant to eligibility under section 174.

- The "depreciable property rule" discussed below is an application of the general definition of research or experimental expenditures and should not be applied to exclude otherwise eligible expenditures.
- The term "pilot model" is defined as any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or implementation of the product.
- The costs of producing a product after uncertainty concerning the development or improvement of a product is eliminated are not eligible under section 174.
- A shrinking-back rule applies when eligibility requirements are met with respect to only a component part of a larger product, but not the overall product itself. T.D. 9680 (eff. July 21, 2014).

Page 88: The R&D credit expired on December 31, 2013, as it has several times since its creation, but it was extended for one year through December 31, 2014. I.R.C. § 41(h)(1)(B), as amended by the Tax Increase Prevention Act of 2014, P.L. 113-295.

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

Pages 90-91: In January 2015, the IRS issued a new set of proposed regulations with respect to internal use software. For tax years ending on or after January 20, 2015, taxpayers will generally be allowed to apply the new, favorable set of proposed regulations. Under the 2015 proposed regulations, internal use software is defined as software that is developed by the taxpayer for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. Software is not developed primarily for internal use if it is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties or if it is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. Thus, software developed to enable a taxpayer to interact with third parties or allow third parties to initiate functions or review data on the taxpayer's system does not have to satisfy the "high threshold of innovation test" discussed below. *See IRS, Proposed Regs Address Research Credit for Internal Use Software*, 2015 TNT 12-15 (Jan. 20, 2015). The 2015 proposed regulations also eliminate the distinction between software developed to deliver computer and non-computer services. They also provide that "dual-function software—software that serves both general, administrative functions and third-party interaction functions—is presumed to be primarily internal-use software, although the portion of research expenditures allocable to the third-party subset may be eligible for the research credit." *Id.* (noting the 2015 proposed regulations provide a safe harbor so that a taxpayer can include 25% of the qualified research expenditures of the dual function software to simplify credit calculation).

Page 91: The 2015 proposed regulations incorporate the high threshold of innovation test, and elaborate on each of the three prongs above for software: (1) it must be innovative, (2) its development must involve significant economic risk, and (3) it is not commercially available for use by the taxpayer. In a positive development, the 2015

proposed regulations state that the first prong (innovative prong) "is not measured by the 'unique or novel nature' of the software but rather by 'a measurable objective standard' based on whether the software would result in substantially and economically significant cost or time savings." *See* Amy S. Elliott, *Favorable Internal-Use Software Research Credit Regs Issued*, 2015 TNT 12-6 (Jan. 20, 2015). The 2015 proposed regulations state the second prong (significant economic risk prong) "requires that, at the beginning of the taxpayer's activities, there be substantial uncertainty that the resources committed to the development of the software will be recovered within a reasonable period." *Id*.

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

Chapter 6
Taxation of Intellectual Property Sales and Licenses

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

Page 191: Similar to the *abandonment* loss deduction described in the main text, section 165 permits a deduction for loss arising from *theft*. In *Sheridan v. Commissioner*, T.C. Memo 2015-25 (Feb. 18, 2015), the taxpayer claimed a large deduction for theft losses that occurred when "pirates" stole the intellectual property underlying a patent that he held. The IRS disallowed the deduction because there was no evidence that patent infringement had occurred or that the taxpayer has incurred actual damages. The Tax Court upheld the IRS's decision disallowing the theft loss deduction, finding that the taxpayer had failed to establish the section 165(e) theft loss requirements.

Chapter 7
Taxation of Intellectual Property Litigation

Page 230: In Chief Counsel Attorney Memorandum, AM 2014-006, 2014 WL 4495163, a generic drug manufacturer sought approval from the Food and Drug Administration for an Abbreviated New Drug Application (ANDA) with Paragraph IV Certification that allows for the testing and development of a generic drug prior to patent expiration. While making or using a patented drug in order to complete an ANDA is not an act of patent infringement, the act of filing an ANDA with Paragraph IV certification constitutes an act of patent infringement, providing courts with jurisdiction to resolve patent issues before actual sale of the generic drug. According to the IRS, the legal fees incurred in defense against patent infringement in relation to the ANDA application process are required to be capitalized under section 263 and Treas. Reg. § 1.263(a)-4(b)(1)(v), -4(d)(5). Capitalization is necessary because the infringement suit pursuant to an ANDA with Paragraph IV Certification is "so integral to the process by which generic drug

manufacturers obtain approval to market and sell a generic version of a drug that the litigation costs to defend the suit are incurred 'in the process of pursuing' such approval." The patent defense originates in a capital transaction—the application for FDA approval to market and sell a generic drug—and the costs of such litigation facilitate the transaction and must be capitalized under Treas. Reg. § 1.263(a)-4(e)(1). [Note: Where a drug manufacturer holds a patent on a drug for which an ANA with Paragraph IV certification is filed, the legal fees incurred by the drug manufacturer to establish the manufacture, use, or sale of the drug subject to the ANDA would infringe the drug manufacturer's patent are generally not required to be capitalized under Treas. Reg. § 1.263(a)-4(d)(9).] Query: Do you agree with IRS's position? Will it make it more costly for brand name and generic pharmaceutical companies to engage in patent litigation?

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

Page 342: For recent rulings denying tax exempt status to software organizations, see Priv. Ltr. Rul. 201514013 (Jan. 6, 2015) (denying tax exempt status to a company that provides software to businesses and nonprofit organizations as well as managerial and consulting services for a fee, because taxpayer's activities are commercial in nature and further the private interests of the founders); Priv. Ltr. Rul. 201507025 (Nov. 18, 2014) (denying tax-exempt status to a computer software developer that sought tax exempt status as a social welfare organization because developing and distributing open-source software does not promote the social welfare of a community and the developer's primary activity is selling software services at cost, similar to a for-profit company); Priv. Ltr. Rul. 201505040 (Nov. 6, 2014) (rejecting the exempt application submitted by an open source software organization that was formed for the purpose of creating, developing, and publishing open source software products for software programmers; such activities "do not serve a charitable class, further an educational purpose, or further a scientific purpose.")

Chapter 11
Use of Domestic Intellectual Property Holding Companies

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

> Once upon a time, before the advent of the shot clock, some basketball teams employed a maneuver known as the "four corners offense." This strategy involved a series of passes among team members that seemingly did not advance the ultimate purpose of putting the ball in the hoop, but had the separate purpose of depriving the opposing team of possession of the ball. In a somewhat analogous enterprise, corporate tax consultants devised a strategy that involved a series of transactions passing licensing rights between related corporations and that was motivated by a desire, not to directly enhance corporate profits, but to keep a portion of those profits

out of the hands of state tax collectors. Much as the shot clock led to the demise of the four corners offense, judicial decisions during the past two decades have limited the utility of this tax avoidance strategy.

Chapter 12
Overview of International Taxation

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

Chapter 13
Use of Foreign Intellectual Property Holding Subsidiaries

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

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

Page 465: Recent years have seen numerous corporate inversions. For an explanation for the recent tide of inversions, *see* Robert Holo & Devin J. Heckman, *Inversions Inside Out*, 2014 TNT 241-7 (Dec. 2, 2014) (describing the benefits and risks associated with modern inversion transactions, and discussing recent proposals to address inversion strategies). For administrative efforts to prevent corporate inversions (and prevent inverted companies from benefiting from certain types of post-inversion restructuring transactions), *see* IRS Notice 2014-52, 2014-43 I.R.B. 712 (announcing the IRS and Treasury will issue regulations aimed at reducing the tax benefits of corporate inversions; noting the regulations would address transactions that are structured to avoid the purposes of sections 7874 and 367). *But see* Devon Bodoh, Greg Featherman, & Stephen M. Massed, *Anti-Inversion Notice: More Questions Than Answers*, 2014 TNT 236-9 (Dec. 9, 2014); Amy S. Elliott, *Questioning the Use of Section 367(d) to Police Repatriations*, 2014 TNT 217-6 (Nov. 10, 2014).

Chapter 14
Transfer Pricing and Cost Sharing Arrangements

Page 477: A number of high profile transfer pricing disputes under section 482 continue to arise. For example, Medtronic, Inc., is involved in a high profile dispute in Tax Court involving more than $2 billion in proposed section 482 transfer pricing adjustments. Medtronic, Inc. v. Commissioner, T.C. No. 6944-11 (2014). *See also* Margaret Burow, *Company Challenges IRS Pricing of Alleged Intangibles Transfers*, 2014 TNT 161-3 (Aug. 20, 2014) (noting Zimmer Holdings, Inc., a manufacturer and seller of medical devices, filed a Tax Court petition challenging the IRS's assessment of $79 million of tax deficiencies, arguing that the IRS ignored contractual terms of transactions involving intangibles between the taxpayer and its foreign subsidiary).

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

Page 487: The IRS completed 101 APAs in 2014, a decrease from the 145 completed in 2013. IRS Announcement 2015-11, 2015 I.R.B. 1 (Mar. 30, 2015).

Chapter 15
Estate Planning for Intellectual Property

Page 543: In 2015, an unmarried decedent's estate of less than $5,430,000 escapes any federal estate tax if the decedent made no lifetime taxable gifts.