

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[REG-129916-07]

RIN 1545-BG76

Patented Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide rules relating to the disclosure of reportable transactions under sections 6011 and 6111 of the Internal Revenue Code (Code). These regulations propose to add the patented transactions category of reportable transaction to the regulations under §1.6011-4 of the Income Tax Regulations. The regulations also include conforming changes to the rules relating to the disclosure of reportable transactions by material advisors under section 6111. The regulations affect taxpayers participating in reportable transactions under section 6011, material advisors responsible for disclosing reportable transactions under section 6111, and material advisors responsible for keeping lists under section 6112.

DATES: Written or electronic comments and requests for a public hearing must be received by December 26, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-129916-07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station,

Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-129916-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-129916-07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Michael H. Beker or Charles D. Wien, (202) 622-3070; concerning the submissions of comments and requests for hearing, Richard Hurst at Richard.A.Hurst@irs.counsel.treas.gov or (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document proposes to amend 26 CFR parts 1 and 301 by adding the patented transactions category of reportable transaction to the rules under section 6011 and by making conforming changes to the rules relating to the disclosure of reportable transactions by material advisors under section 6111.

On November 1, 2006, the IRS and Treasury Department issued a notice of proposed rulemaking and temporary and final regulations under sections 6011, 6111, and 6112 (REG-103038-05, REG-103039-05, REG-103043-05, TD 9295) (the November 2006 regulations). The November 2006 regulations were published in the **Federal Register** (71 FR 64488, 71 FR 64496, 71 FR 64501, 71 FR 64458) on November 2, 2006. In the preamble to those proposed regulations, the IRS and Treasury Department expressed concern, shared by many commentators, regarding the patenting of tax advice or tax strategies that

have the potential for tax avoidance. A patent for tax advice or a tax strategy might be interpreted by taxpayers as approval by the IRS and Treasury Department of the transaction, which might impede the efforts of the IRS and Treasury Department to obtain information regarding tax avoidance transactions and have an impact on effective tax administration. Consequently, the IRS and Treasury Department requested comments regarding the creation of a new category of reportable transaction to address these concerns.

The IRS and Treasury Department received written public comments responding to the proposed regulations and held a public hearing regarding the proposed rules on March 20, 2007. After consideration of the comments received, the IRS and Treasury Department are issuing these proposed regulations with respect to patented transactions. Upon publication of final regulations, these regulations will be effective for transactions entered into on or after the date of publication of this notice of proposed rulemaking.

Explanation of Provisions

In response to the request for comments, the IRS and Treasury Department received five comments regarding the creation of a new category of reportable transaction to address the patenting of tax advice or tax strategies. One commentator suggested that the patenting of tax advice or tax strategies should not be addressed through the addition of a new category of reportable transaction. The commentator suggested that the IRS should require a form of notification or have a disclosure requirement informing the IRS when the United States Patent and Trademark Office (USPTO) issues a tax strategy patent. The

commentator suggested that this could be accomplished through cooperation between the IRS and the USPTO. To the extent cooperation does not result in the necessary disclosures, the commentator suggested that the current reportable transaction regime or another mechanism could provide the necessary notifications and disclosures.

One commentator suggested that the patenting of tax advice or tax strategies should be addressed through the transaction of interest category of reportable transaction under §1.6011-4(b)(6). The commentator suggested that each application for, or grant of a patent be automatically included within the scope of a transaction of interest, thereby requiring anyone who “participated” in the transaction to file a disclosure statement. In addition, the commentator suggested that the party who files an application for a patent, or for whom a patent is granted, be considered a material advisor, as defined in §301.6111-3(b) of the Procedure and Administration Regulations. The commentator noted that treating the patent applicant or holder as a material advisor would obligate that party to file a disclosure statement under §301.6111-3 and also to maintain an investor list under §301.6112-1. Further, the commentator proposed that each material advisor should be required to disclose to each taxpayer on that material advisor’s list of investors that the transaction is a transaction of interest and that the taxpayer is required to disclose the transaction.

Two commentators suggested the creation of a new category of reportable transaction for taxpayers who participate in a transaction that uses a patented tax strategy for each year in which the taxpayer’s return reports items attributable to

such transaction. The two commentators both suggested treating the patent holder as a material advisor within the meaning of section 6111. One of the two commentators suggested lowering the gross income threshold amounts for material advisors in §301.6111-3(b)(3). One of the commentators recommended that a material advisor should only include the owner of the patent and advisors who pay fees directly or indirectly for the patented tax strategy or advice. This commentator also recommended that the disclosure obligations be narrowly construed so as not to apply to those taxpayers and material advisors who implement patented tax strategies and provided advice without any knowledge that the tax strategy or advice has been patented.

Another commentator also recommended limiting the scope of a category of reportable transaction for patents so that the category applies only to those taxpayers and material advisors who have a legal right to use the patented tax strategy or tax advice. Finally, commentators recommended excluding from the category of reportable transaction the use of patented tax methods or processes for complying with return preparation and filing and other administrative requirements.

After careful consideration of the comments received, the IRS and Treasury Department continue to be concerned about the patenting of tax advice or tax strategies and believe that adding a new category of reportable transaction to the section 6011 regulations for patented transactions will assist the IRS and Treasury Department in obtaining disclosures of tax avoidance transactions and in providing effective tax administration. Under the new category of reportable

transactions, the “patented transaction” is a transaction for which a taxpayer pays (directly or indirectly) a fee in any amount to a patent holder or the patent holder’s agent for the legal right to use a tax planning method that the taxpayer knows or has reason to know is the subject of the patent. A patented transaction also is a transaction for which a taxpayer (the patent holder or the patent holder’s agent) has the right to payment for another person’s use of a tax planning method that is the subject of the patent.

The proposed regulations exclude mathematical calculations or mechanical assistance in the preparation of tax returns from the patented transaction category of reportable transactions. Thus, a patented transaction does not include patent-protected tax preparation software or other tools used to perform or model mathematical calculations or to provide mechanical assistance in the preparation of tax or information returns.

For purposes of the new patented transaction category, a taxpayer has participated in a patented transaction if the taxpayer’s tax return reflects a tax benefit from the transaction (including a deduction for fees paid in any amount to the patent holder or patent holder’s agent). A taxpayer also has participated in a patented transaction if the taxpayer is the patent holder or patent holder’s agent and the taxpayer’s tax return reflects a tax benefit in relation to obtaining a patent for a tax planning method (including any deduction for amounts paid to the United States Patent and Trademark Office as required by title 35 of the United States Code and attorney’s fees) or reflects income from a payment received

from another person for the use of the tax planning method that is the subject of the patent.

These regulations also describe when a person is a material advisor with respect to a patented transaction under section 6111. Because of the nature of patented transactions and how those transactions are marketed, the threshold amount as described in section 6111(b) is reduced from \$50,000 to \$250 and from \$250,000 to \$500. A person who is a material advisor with respect to a patented transaction will have a list maintenance obligation under section 6112.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that most information is already required to be reported on the disclosure statement referenced in the regulation and approved under OMB control number 1545-0074; the new information required by these proposed regulations add little or no new burden to the existing requirements. Therefore, a Regulatory Flexibility Analysis under the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will

be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules, how they can be made easier to understand, and the administrability of the rules in the proposed regulations. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that submits timely written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Michael H. Beker and Charles D. Wien, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6011-4 is amended by:

1. Revising paragraphs (b)(7) and (c)(3)(i)(F).
2. Adding to paragraph (c)(3)(ii) Examples 4, 5, 6, and 7.
3. Revising paragraph (h)(2).

The revisions and additions read as follows:

§1.6011-4 Requirement of statement disclosing participation in certain transactions by taxpayers.

* * * * *

(b) * * *

(7) Patented transactions--(i) In general. A patented transaction is a transaction for which a taxpayer pays (directly or indirectly) a fee in any amount to a patent holder or the patent holder's agent for the legal right to use a tax planning method that the taxpayer knows or has reason to know is the subject of the patent. A patented transaction also is a transaction for which a taxpayer (the

patent holder or the patent holder's agent) has the right to payment for another person's use of a tax planning method that is the subject of the patent.

(ii) Definitions. For purposes of this paragraph (b)(7), the following definitions apply:

(A) Fee. The term fee means consideration in whatever form paid, whether in cash or in kind, for the right to use a tax planning method that is the subject of a patent. The term fee includes any consideration the taxpayer knows or has reason to know will be paid indirectly to the patent holder or patent holder's agent, such as through a referral fee, fee-sharing arrangement, or license. The term fee does not include amounts paid in settlement of, or as the award of damages in, a suit for damages for infringement of the patent.

(B) Patent. The term patent means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. See §1.1235-2(a). The term patent includes patents that have been applied for but not yet granted.

(C) Patent holder. A person is a patent holder if--

(1) The person is a holder as defined in §1.1235-2(d) and (e);

(2) The person would be a holder as defined in §1.1235-2(d)(2) if the phrase S corporation or trust was substituted for the word partnership and the phrase shareholder or beneficiary was substituted for the words member and partner;

(3) The person is an employer of a holder as defined in §1.1235-2(d) and the holder transferred to the employer all substantial rights to the patent as defined in §1.1235-2(b); or

(4) The person receives all substantial rights to the patent as defined in §1.1235-2(b) in exchange (directly or indirectly) for consideration in any form.

(D) Patent holder's agent. The term patent holder's agent means any person who has the permission of the patent holder to offer for sale or exchange, to sell or exchange, or to market a tax planning method that is the subject of a patent. The term patent holder's agent also means any person who receives (directly or indirectly) for or on behalf of a patent holder a fee in any amount for a tax planning method that is the subject of a patent.

(E) Payment. The term payment includes consideration in whatever form paid, whether in cash or in kind, for the right to use a tax planning method that is the subject of a patent. For example, if a patent holder or patent holder's agent receives payment for a patented transaction and a separate payment for another transaction, part or all of the payment for the other transaction may be treated as payment for the patented transaction if the facts and circumstances indicate that the payment for the other transaction is in consideration for the patented transaction. The term payment also includes amounts paid in settlement of, or as the award of damages in, a suit for damages for infringement of the patent.

(F) Tax planning method. The term tax planning method means any plan, strategy, technique, or structure designed to affect Federal income, estate, gift, generation skipping transfer, employment, or excise taxes. A patent issued

solely for tax preparation software or other tools used to perform or model mathematical calculations or to provide mechanical assistance in the preparation of tax or information returns is not a tax planning method.

(iii) Related parties. For purposes of this paragraph (b)(7), persons who bear a relationship to each other as described in section 267(b) or 707(b) will be treated as the same person.

* * * * *

(c) * * *

(3) * * *

(i) * * *

(F) Patented transactions. A taxpayer has participated in a patented transaction, as defined in paragraph (b)(7) of this section, if the taxpayer's tax return reflects a tax benefit from the transaction (including a deduction for fees paid in any amount to the patent holder or patent holder's agent). A taxpayer also has participated in a patented transaction, as defined in paragraph (b)(7) of this section, if the taxpayer is the patent holder or patent holder's agent and the taxpayer's tax return reflects a tax benefit in relation to obtaining a patent for a tax planning method (including any deduction for amounts paid to the United States Patent and Trademark Office as required by title 35 of the United States Code and attorney's fees) or reflects income from a payment received from another person for the use of the tax planning method that is the subject of the patent.

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(ii) * * *

Example 4. (i) A, an individual, creates a tax planning method and applies for a U.S. patent. A pays attorney fees in relation to obtaining the patent and A pays the fee required under title 35 of the United States Code for the patent application. Subsequently, C pays a fee to A for the legal right to use the tax planning method that C knows or has reason to know is the subject of A's patent. A's tax return reflects both a deduction for an amount paid in relation to obtaining a patent and income from C's payment to A for the legal right to use the tax planning method that is the subject of the patent. C's tax return reflects a deduction for an amount paid to A for the right to use the tax planning method that is the subject of the patent.

(ii) A is a patent holder under paragraph (b)(7)(ii)(C)(1) of this section. The transaction is a reportable transaction for A under paragraph (b)(7) of this section because A has the right to payment for another person's use of the tax planning method that is the subject of the patent. The transaction is a reportable transaction for C under paragraph (b)(7) of this section, because C paid a fee to A for the legal right to use a tax planning method that C knew or had reason to know was the subject of a patent. A has participated in the transaction in the year in which A's tax return reflects a tax benefit in relation to obtaining the patent or reflects income from C's payment to A for the legal right to use the tax planning method that is the subject of the patent. C has participated in the transaction in the year in which C's tax return reflects the deduction for any amount paid to A for the legal right to use the tax planning method that is the subject of the patent. C also participates in the transaction for any years for which any other tax benefit from the transaction is reflected on C's tax return.

Example 5. (i) A, an individual, is the employee of B, a corporation. A creates a tax planning method and applies for a U.S. patent but B pays the fee required under title 35 of the United States Code for A's patent application. Pursuant to A's employment contract with B, B holds all substantial rights to the patent. B's tax return reflects a deduction for the amount paid in relation to obtaining the patent.

(ii) A and B are patent holders under paragraph (b)(7)(ii)(C)(1) and (3) of this section, respectively. The transaction is not a reportable transaction for A under paragraph (b)(7) of this section because A does not have the right to payment for another person's use of the tax planning method that is the subject of the patent. The transaction is a reportable transaction for B under paragraph (b)(7) of this section because B holds all substantial rights to the patent and has the right to payment for another person's use of the tax planning method that is the subject of the patent. B has participated in the transaction in the year in which B's tax return reflects a tax benefit in relation to obtaining the patent. B also participates in the transaction for any years for which B's tax return reflects

income from a payment received from another person for the use of the tax planning method that is the subject of the patent.

Example 6. (i) Assume the facts as in Example 4, except that A agrees to license the patent to F, a financial institution. The license agreement between A and F provides that F may offer the tax planning method to its clients and if a client decides to use the tax planning method, F must pay A for each client's use of the tax planning method. F offers the tax planning method to G who uses the tax planning method and knows or has reason to know it is the subject of a patent. F charges G for financial planning services and pays A for G's use of the tax planning method. A's tax return reflects income from the payment received from F. F's tax return reflects income from the payment received from G, and G's tax return reflects a deduction for the fees paid to F.

(ii) F is a patent holder's agent under paragraph (b)(7)(ii)(D) of this section because F has the permission of the patent holder to offer for sale or exchange, to sell or exchange, or to market a tax planning method that is the subject of a patent. F also is a patent holder's agent under paragraph (b)(7)(ii)(D) of this section because F receives (directly or indirectly) a fee in any amount for a tax planning method that is the subject of a patent for or on behalf of a patent holder. The transaction is a reportable transaction for both A and F under paragraph (b)(7) of this section because A and F each have the right to payment for another person's use of the tax planning method that is the subject of the patent. The transaction is a reportable transaction for G under paragraph (b)(7) of this section because G paid a fee (directly or indirectly) to a patent holder or a patent holder's agent for the legal right to use a tax planning method that G knew or had reason to know was the subject of the patent. A has participated in the transaction in the years in which A's tax return reflects income from the payment received from F for G's use of the tax planning method that is the subject of the patent. F has participated in the transaction in the years in which F's tax return reflects income from the payment received from G for use of the tax planning method that is the subject of the patent. G has participated in the transaction in the years in which G's tax return reflects a deduction for the fees paid to F. G also participates in the transaction for any years for which any other tax benefit from the transaction is reflected on G's tax return.

Example 7. Assume the same facts as in Example 4. J uses a tax planning method that is the same as the tax planning method that is the subject of A's patent. J does not pay any fees to any patent holder or patent holder's agent with respect to the tax planning method that is the subject of the patent. A sues J for infringement of the patent and J pays A an amount for damages. A's tax return reflects as income the amounts for damages received from J. The transaction is not a reportable transaction for J under paragraph (b)(7) of this section because J did not pay any fees (as defined in paragraph (b)(7)(ii)(A) of this section) (directly or indirectly) to a patent holder or patent holder's agent for the legal right to use a tax planning method that J knew or had reason to know

was the subject of the patent. A has participated in a reportable transaction under paragraph (b)(7) of this section in the year in which A's tax return reflects income from a payment (the amount received as an award for damages in a suit for damages for infringement of the patent) received from another person for the use of the tax planning method that is the subject of a patent.

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(h) * * *

(2) Patented transactions. Upon the publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, paragraphs (b)(7), (c)(3)(i)(F), and (c)(3)(ii) Examples 4 through 7 of this section will apply to transactions entered into on or after September 26, 2007.

PART 301--PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 4. Section 301.6111-3 is amended by revising paragraphs (b)(2)(ii)(E), (b)(3)(i)(C), and (i)(2) to read as follows:

§301.6111-3 Disclosures of reportable transactions.

* * * * *

(b) * * *

(2) * * *

(ii) * * *

(E) Patented transactions. A statement relates to a tax aspect of a transaction that causes it to be a patented transaction if the statement is made or provided by the patent holder or by the patent holder's agent, as defined in

§1.6011-4(b)(7)(ii)(C) or (D) of this chapter, and concerns the tax planning method that is the subject of the patent.

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(3) * * *

(i) * * *

(C) Patented transactions. For patented transactions described in §1.6011-4(b)(7) of this chapter, the threshold amounts in §301.6111-3(b)(3)(i)(A) are reduced from \$50,000 to \$250 and from \$250,000 to \$500.

* * * * *

(i) * * *

(2) Patented transactions. Upon the publication of the Treasury decision adopting these rules as final regulations in the Federal Register, paragraphs (b)(2)(ii)(E) and (b)(3)(i)(C) of this section will apply to transactions with respect to which a material advisor makes a tax statement on or after September 26, 2007.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.