

January 31, 2008

CC:PA:LPD:PR (REG-129916-07)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on proposed regulations concerning the reporting of patented transactions

Dear Sir/Madam:

This letter sets forth the views of the Securities Industry and Financial Markets Association ("SIFMA")¹ on the proposed regulations that would add a "patented transactions" category of reportable transactions and require participants and material advisors in patented transactions to report the transactions to the IRS (the "Proposed Regulations").²

Introduction and Background

Beginning in the late 1990's, patent issues became of increasing importance in the financial services industry primarily as a result of information technology advances, deployment of those technologies by SIFMA members and new legal precedent confirming an expansive U.S. patent regime. From the outset, SIFMA and its predecessor organizations have been active voices in advocating for a patent system that achieves and maintains a balance between the rights of patent holders and the public's right to access fundamental structures, and that promotes interoperability between the complex technologies comprising much of the financial services industry and financial market infrastructure.

The financial industry relies on extensive interdependencies between brokerage firms, banks, depositories, data processors, market data vendors, exchanges, and clearing entities. Many parts of the systems involved embody extensive investments in

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

² 72 Fed. Reg. 54615-01, 2007-43 I.R.B. 891.

intellectual property, including patented devices, software and technology driven processes. Most, if not all, of these types of patents can have some effect on taxes.

The Proposed Regulations would amend the existing regulatory scheme for “reportable transactions” provided in sections 1.6011-4 and 301.6111-3 of the Treasury regulations. Generally, under these regulations, taxpayers who participate in “reportable transactions” and material advisors to these transactions must disclose the transactions to the IRS. Penalties are imposed if these reporting obligations are not met. The Proposed Regulations would expand the reporting requirements to include transactions covered by a patent or a patent application for a tax planning method. In doing so, the proposed rules would not distinguish between patents involving acceptable tax planning methods and patents involving transactions that have a potential for tax avoidance or evasion. Further, they would appear to extend to patents on primarily nontax strategies that also affect Federal taxes.

The preamble to the Proposed Regulations states that “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 . . . will assist the IRS and Treasury Department in obtaining disclosures of tax avoidance transactions and in providing effective tax administration.” We recognize the merit and benefits of discouraging the patenting of tax strategies or techniques and the need for the IRS to obtain information regarding tax avoidance transactions. However, SIFMA believes that the Proposed Regulations are not the most effective means of achieving these goals. We believe that legislation, as proposed by Congress, is a more direct and effective means of addressing concerns with the patenting of tax advice or tax strategies. However, if there are to be new reporting requirements under section 6011, any new rules should be developed in close coordination with legislators looking at the same issues and be better targeted to improve administrability, reduce market uncertainty, avoid unnecessary reporting obligations and eliminate unwarranted exposure to penalties. Our comments are discussed in greater detail below.

Broad Recommendations

Coordination with Congress. We share the concerns of the IRS and Treasury Department as to the patenting of tax advice or tax strategies that relate to abusive tax avoidance transactions and understand the need to obtain information about these transactions. Congress also has concerns about patenting tax strategies and has proposed legislation to prohibit patents for certain tax strategies. The Proposed Regulations and the legislative proposals under consideration are being developed in parallel and it is unclear how the new regulations would apply if the legislation were enacted. Because the legislation would prohibit the patenting of certain tax strategies, enactment of any of the versions of the patent bills currently being considered by Congress would render aspects of the Proposed Regulations obsolete.³ As a result, we strongly recommend close coordination between the Treasury Department and Congress in the development of a single approach to address

³ See S. 681 (110th Cong.); S. 2369 (110th Cong.); H.R. 1908 (110th Cong.); H.R. 2136 (110th Cong.); see also H.R. 2365 (110th Cong.) (proposing limitations on remedies for infringement of tax planning methods)

tax planning patents. At a minimum, we believe the Proposed Regulations should not be finalized until Congress enacts legislation, in order to ensure that the final regulations function properly in conjunction with the legislation in its final form.

Transactions patented primarily for nontax reasons. As currently drafted, we believe the Proposed Regulations would require reporting of patented transactions that have a U.S. tax element but which are not *primarily* tax motivated strategies. The strategic reasons for patenting financial strategies generally do not relate to tax. First, a financial institution may invest significant resources in the development of financial technology that may make market transactions more efficient, reduce risk or have some other utility in addition to effects on tax liability, which may be minor side-effects of the technology. A patent may be used as a means to protect the firm's investments in such technology. Second, a financial strategy patent may provide a financial institution with a marketing advantage over its competitors who do not hold a patent or have a patent pending for that strategy. Third, a financial institution may file for a patent as part of a defensive strategy. Such institution may believe that obtaining a patent for one financial strategy provides "insurance" against patent infringement claims by a competitor with respect to use of the competitor's patented strategy. Because financial institutions increasingly seek patent protection for a variety of strategic reasons, there are patents and patent applications for multiple financial strategies that are "designed to affect" Federal income tax but that are not primarily tax strategies. SIFMA believes transactions that are not primarily tax motivated strategies should not be subject to reporting.

Patented transactions that are not tax avoidance transactions. The Proposed Regulations as currently drafted would require the disclosure of many types of transactions that are not tax avoidance transactions. For example, a strategy to raise capital may be designed to result in deductible interest payments through the issuance of an instrument, such as a unit comprised of a debt instrument and forward contract, that is treated as debt for tax purposes and as equity for one or more non-tax purposes. Such a strategy is designed to affect Federal income tax but is clearly not a tax avoidance strategy.⁴ Requiring disclosure of common transactions "designed to affect" Federal income tax would result in a plethora of disclosures that would not further the stated purpose of disclosing tax avoidance transactions or providing effective tax administration.⁵ In addition, a patent also could be obtained for a structure that the IRS and Treasury Department have already reviewed and accepted, such as contingent convertible debt.⁶

If the proposed regulations are intended to address concerns over abusive transactions, the class of patents that the regulations cover should be more narrowly defined. This could be achieved by limiting the definition of a "tax planning method" to include only plans, strategies, techniques or structures with a principal purpose to avoid

⁴ See Rev. Rul. 2003-7 (analyzing a unit comprised of a 5-year debt instrument and a 3-year forward contract on the issuer's stock, and concluding that the interest payments on the debt instrument were deductible).

⁵ The IRS has encountered this problem already in the context of the overbroad Notice 2002-35, for which Notice 2006-16 was needed to narrow the scope of the transactions subject to disclosure.

⁶ See, e.g., Rev. Rul. 2002-31 (analyzing a contingent convertible debt instrument); U.S. Patent No. 7,219,079 (patent on contingent convertible debt instrument).

Federal taxes and to exclude any plan, strategy, technique or structure on which the IRS has favorably ruled. In addition, many financial structures are already in the public domain because registration statements for the products have been filed with the Securities and Exchange Commission. It is our view that these structures also should be exempted from the category of “patented transactions.”

Unnecessary reporting by participants in patented transactions. The Proposed Regulations would impose excessive reporting requirements on taxpayers who *participate* in a patented transaction. As described above, taxpayers may participate in a patented financial transaction for a reason other than tax avoidance, although the financial transaction may have an effect on Federal taxes. The information desired by the IRS and Treasury Department about such transactions could be obtained by requiring only the patent *holder* to disclose transactions to the IRS. The most efficient manner to accomplish this would be to require the patent holder to report the application to the IRS in the year the application is filed (and perhaps again in the year the patent is granted). The patent holder could then be required to maintain a list of completed transactions in a manner similar to the list maintenance requirements for material advisors. After reviewing the patent, if the IRS determines that the patented strategy is an abusive tax avoidance strategy or otherwise requires additional scrutiny, the IRS could obtain additional information about participants directly from the patent holder. This method would greatly reduce the amount of paper initially collected by the IRS and eliminate the reporting obligations for participants without, we believe, adversely affecting the ability of the IRS and Treasury Department to obtain the desired information and enforce the tax laws.

Excessive exposure to risk of penalties. Section 6707A of the Internal Revenue Code imposes a penalty upon failure to report information with respect to a transaction that is required to be reported under section 6011 and is “of a type which the Secretary determines as having a potential for tax avoidance or evasion.” SIFMA members are concerned that the broad language in the Proposed Regulations would introduce significant uncertainty concerning the risk of penalties and, in doing so, create an unnecessary burden on market participants and technology vendors to the industry. The Proposed Regulations should be narrowly targeted to minimize the risk of unwarranted penalties.

Specific Comments

In addition to our broader comments above, we make the following specific comments to the proposed regulations.

1. Definition of “tax planning method”. As mentioned above, we believe this definition is overbroad and should be significantly narrowed. The current definition includes any plan, strategy, technique or structure “designed to affect” Federal taxes. Unless this standard is fashioned more narrowly, the “designed to affect” standard in the Proposed Regulations would encompass virtually any financial transaction. A taxpayer would be treated as a participant in such transaction and would be required to file a disclosure statement if it paid a fee to the patent holder for the legal right to use such strategy. In addition, while the phrase “designed to affect” implies that the tax effect must be an integral part of the patent, this is far from clear.

If the regulations are to be finalized, we recommend defining a “tax planning method” as any plan, strategy, technique or structure *with a principal purpose of avoiding Federal tax* and which gives rise to a “tax benefit” as defined in Treasury Regulation Section 1.6011-4(c)(6). We also recommend exempting from the definition of a “tax planning method” any plan, strategy, technique or structure for which the IRS has issued a public or private ruling, notice, announcement or similar guidance clearly accepting the purported tax treatment. In addition, the definition should clarify that the tax planning method must be one which is necessarily covered by the claims in the patent (*i.e.*, one cannot practice the method without infringing upon the claims in the patent). Finally, we believe there is no need to separately report any transaction that is in the public domain (*e.g.*, that has been filed with the Securities and Exchange Commission).

2. Definition of “fee”. This definition is potentially overbroad. While the proposed regulations limit a “fee” to consideration paid for the “right to use a tax planning method that is the subject of a patent,” the scope of this limitation is unclear.

First, in many situations a patent holder may receive market rate compensation for services unrelated to the patent. For example, in the offering for a capital markets security that is described in a patent, the patent holder and another financial institution acting as joint underwriters may receive market rate compensation to underwrite the offering. No additional consideration may be received by the patent holder as compared to the other underwriter because no additional services or property are provided. In some cases, the patent holder may have no involvement in structuring the security and may only get involved in the offering shortly before distribution commences.

Second, a patent holder may participate in a transaction as a principal with its own funds at risk and not as an advisor to any other participant. In such a case, the patent holder may receive nothing in exchange for the use of the patent because it is using the patented technology for its own benefit and putting its own capital at risk.

Finally, if a taxpayer fails to pay any consideration to a patent holder because the parties agree that no fee is payable, it is not entirely clear under the regulations whether the transaction is reportable. While “patented transaction” is defined as a transaction in which a taxpayer pays a fee for the right to use a tax planning method that the taxpayer knows or has a reason to know is subject to a patent, does failure to pay a fee render the proposed regulations inapplicable if the taxpayer knows, or has reason to know, that the transaction is subject to a patent?⁷

We recommend modifying the definition of “fee” to exclude market rate compensation provided to the patent holder for services or property unrelated to the legal right to use the tax planning method. Alternatively, additional examples of situations in which a patent holder receives a payment that is not for the legal right to use the tax planning method would be helpful. In addition, the definition of “fee” should exclude amounts paid to a patent holder or its agent in that person’s capacity as a party to the transaction, similar to the exclusion

⁷ Example 7 in the proposed regulations does not directly address this issue because the taxpayer in that example did not know or have reason to know that the tax planning method was covered by a patent.

provided in the “material advisor” regulations.⁸ Finally, we recommend clarifying that both the fee requirement and knowledge requirement must be satisfied before a transaction becomes reportable, and conversely, that failure to satisfy *either* the fee requirement *or* knowledge requirement would cause the transaction to not be reportable. Another way to simplify the knowledge requirement would be to require reporting only with respect to issued patents classified as tax strategies by the U.S. Patent and Trademark Office.⁹

3. Definition of “patent”. The definition of “patent” is overbroad because it includes patent applications. Applying for a patent does not ensure that a patent will be issued. A patent can be denied for many reasons. For example, a patent may be denied if the strategy is in the public domain or the strategy is simply not patentable under U.S. patent law. In addition during the application review period before the patent is granted, it is common for the patent application to be modified to reflect comments from the U.S. Patent and Trademark Office. Often the transactions covered by the patent that is ultimately granted are substantially narrower than the transactions described in the patent application. Under the Proposed Regulations, a transaction could be reportable as a patented transaction even if no patent covering the transaction is ever issued. We therefore recommend limiting the definition of “patent” in the reportable transaction regulations to include only patents that have been granted. For earlier information about applications for patents covering strategies or transactions with a principal purpose of avoiding Federal income tax, information could be collected either directly from the U.S. Patent and Trademark Office or by requiring patent application filers to report the patent application filing to the IRS.

4. Interaction between “participation” and “patented transaction” rules. Technically, the rules relating to “participation” by a patent user and a patent holder do not interact properly with the definition of a “patented transaction.”

First, with respect to the patent user, a patented transaction is a transaction for which the taxpayer pays a fee to the patent holder. However, to be a “participant”, the rules require only that the patent user’s tax return reflect a tax benefit from the transaction (which may include a deduction for fees paid). For internal consistency, the “participant” rules should require that a patent user is a taxpayer who has paid a fee (the examples are clear on this point). With respect to the patent holder, a “patented transaction” includes a transaction for which the patent holder “has the right to payment” for another person’s use of a tax planning method that is the subject of the patent. Example 5 makes it clear that a “right to payment” is a theoretical legal right to payment, *if and when* the patent is used. This will require difficult legal judgments that will inevitably lead to different interpretations. Once the patent application is filed, the transaction will always be a reportable transaction as to the patent holder because it will always have the legal right to payment. However, a patent holder is a “participant” when its tax return reflects a tax benefit in relation to obtaining the patent (*i.e.*, when it pays and takes a deduction for attorney’s fees associated with filing the patent application). Consequently, it appears that a taxpayer filing a patent application will

⁸ Treas. Reg. §301.6111-3(b)(3)(ii).

⁹ Under the patent classification system of the U.S. Patent and Trademark Office, tax strategies are classified in class 705/36T.

always be a participant, even if a patent user doesn't exist. The rule should be corrected to properly integrate the "user" and "holder" rules to avoid this result.

Second, because a "patented transaction" with respect to the patent holder includes transactions where the patent holder merely has the legal right to receive the fee, the patent holder may be wholly unaware of the transaction. Notwithstanding this lack of knowledge, the patent holder would be a participant required to disclose the transaction if its tax return reflects a deduction for expenses related to obtaining the patent. We recommend limiting the definition of a patent holder's participation to situations in which a patent holder has knowledge or has reason to have knowledge of the transaction. This could be achieved by adding a knowledge requirement when participation is evidenced by the deduction of application costs.

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Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-962-7326 or pmcclanahan@sifma.org) if SIFMA can be of help with respect to any aspect of your work on tax patents.

Sincerely,

Patti McClanahan
Managing Director, SIFMA

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