

Credits, Costs & Technology: Tax Update

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Note: At the time this outline was submitted, Congress had passed H.R. 4520 (American Jobs Creation Act of 2004), but the President had not yet signed it. Some of the proposed provisions, such as new §199, a manufacturing incentive, is included in this outline. The text of any resulting Public Law should be reviewed as H.R. 4520 includes many provisions applicable to all businesses.

I. Developing and Acquiring Intellectual Property and Products

R&D Review

- n §174 – (a) expense, or (b) elect to capitalize & amortize (minimum 60 months)
- n §174(a) – may also annually elect to capitalize and amortize all or part over 10 years per §59(e)
- n §41 – credit for increasing research activities
- ü Temporary provision since 1981
- ü QRE (qualified research expenditures) smaller than §174 – wages, supplies + 65% contract research expenditures
- ü 20% x [QRE less base amount] + 20% x basic research payments OR use alternative incremental research credit formula
- ü Must be for “qualified research”
- ü Only for research conducted in US, Puerto Rico and US possessions
- ü §280C(c) – must reduce §174 amount by credit amount

1. Proposed Regulations on §59(e) Elections (REG-124405-03; 7/20/04)

Proposed regulations were finally issued under §59(e), added by the TRA '86. Guidance relevant to §59(e) elections for §174(a) expenditures includes:

- § §59(e) allows any qualified expenditure to which a §59(e) election applies to be deducted ratably over 10 years beginning with the tax year in which the expenditures was made.
- § The election may be made for all or any portion of the qualified expenditure.
- § A §59(e) election may only be made by attaching a statement to the tax return for the year in which the amortization begins.
- § A separate §59(e) election must be made for each specific activity or project. The statement must be filed no later than the due tax (including extensions) of the tax return. The statement must include:
 - o Taxpayer’s name, address, and TIN
 - o Type and amount, for each activity/project, of qualified expenditures for which the taxpayer elects ratably amortization over 10 years
 - o A description of each specific activity or project to which the qualified expenditures pertain
 - o The specific dollar amount of the election amount. The amount may not be noted by reference to a formula.
- § A §59(e) election may only be revoked with IRS consent. “Such consent will only be granted in rare and unusual circumstances.” If granted, the revocation is effective for the first tax year in which the §59(e) election was applicable unless the period of limitations has expired in which case it will be effective in the earliest open tax year. Request for consent to revoke the election must be submitted prior to the end of the tax year the §59(e) period ends. The revocation request is submitted in the form of a private letter ruling request and state why IRS consent should be given. If the revocation is granted, unamortized costs under the §59(e) election are deductible in the year the revocation is effective and the taxpayer must amend any tax returns affected by the revocation.

§ The proposed regulations are effective once the final regulations are published in the Federal Register.

2. Final Research Credit Regulations (TD 9104)

The research credit, enacted in 1981, was modified by the Tax Reform Act of 1986. Additional requirements were added to what constitutes *qualified research* (prior to that time, the §174 definition was used). Terms, such as discovering information, technological in nature and process of experimentation, were not clear. Some (particularly the IRS and a few judges) found the terms to mean a breakthrough discovery, while others found the terms to mean particular types of research needed when it wasn't obvious how to make something happen. Proposed regulations were issued in 1998 (for 1986 legislative changes!); final regulations were issued in January 2001 in the last days of the Clinton administration. These regulations were pulled in January 2001 (in the first few days of the Bush administration), proposed regulations were issued in December 2001 with final regulations issued in January 2004 (TD 9104). The final regulations address “qualified research,” the exclusions from the definition of qualified research and the shrinking back concept. However, one exclusion –for certain internal-use software, is addressed in proposed regulations (discussed in the next section of the outline).

§41 Review: Per §41(d)(1), qualified research means research –

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of *discovering information* –

(i) which is *technological in nature*, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) *substantially all* of the activities of which constitute elements of a *process of experimentation* for a purpose that relates to a new or improved function, performance, or reliability or quality.

Highlights of the final regulations (including the preamble to the regulations):

§ “Discovering information”

- Research satisfies this requirement if it is “intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.”

How does this compare to the uncertainty rule of §174? Per §1.174-2:

Expenditures represent R&D costs in the "experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. 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."

Query: Given §41(d)(1)(A), why would Congress have repeated that requirement with the “discovering information” phrase at §41(d)(1)(B)?

- Taxpayers do *not* have to be “seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research.” Also, there is no need to succeed.

- Issuance of a patent is conclusive evidence that the discovering information requirement was met.
- § Technological in nature is met if the process of experimentation used to discover information fundamentally relies on the principles of the physical or biological sciences, engineering or computer science.
- § *Process* of experimentation “implies that research activities must contain certain core elements in order to constitute a process of experimentation.”
- § The process must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science.
- § The “core elements” of a process of experimentation – 3 things that the taxpayer must identify:
- The uncertainty that exists regarding the development or improvement of a business component that is the object of the taxpayer’s research activities
 - 1 or more alternatives intended to eliminate the uncertainty
 - a process of evaluating the alternatives (and the taxpayer must conduct that process too)
- § “A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative.”
- § “A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer’s capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer’s research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.”
- § Substantially all – 80% or more of the research activities, as measured by cost or other “consistently applied reasonable basis,” must be elements of a process of experimentation. Thus, as long as the other 20% satisfy the other requirements of §41(d)(1)(A) and are not excluded under §41(d)(4), the substantially all requirement is met.
- § Shrinking back rule – the definition of qualified research is to be “applied first at the level of the discrete business component, that is, the produce, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer.” If not met at that level, keep shrinking back to find if there is a subset of the larger item to which the definition of qualified research is met. This rule is not intended to serve to exclude activities from being qualified research.
- § Additional guidance is provided for some of the exclusions from qualified research, such as for clinical testing and apportionment of in-house research expenses performed both in the U.S, Puerto Rico and other US possessions and outside of these areas.
- § Recordkeeping – The general recordkeeping rules of §1.6001-1 apply. The IRS and taxpayers may agree to guidelines on how to keep specific records to substantiate the credit.
- § Effective date – tax years ending after 12/31/03. However, for earlier tax years, the IRS will not challenge positions taken that are consistent with the final regulations.

3. Notice of Proposed Rulemaking – Internal-use software and §41 (REG-153656-03 and Ann. 2004-9, 2004-6 IRB 441)

§41 Review: An excluded activity provided for at §41(d)(E) is – “Computer software. Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in—

- (i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
- (ii) a production process with respect to which the requirements of paragraph (1) are met.”

Per the legislative history to the Tax Reform Act of 1986 which tightened up the research credit rules, the costs of new or improved internal use software will only be eligible for the credit if the software is innovative, its development involves significant economic risk, and the software is not commercially available to the taxpayer; see *General Explanation to the Tax Reform Act of 1986* (Blue Book), prepared by the staff of the Joint Committee on Taxation, page 135, and Notice 87-12 (1987-1 CB 432).

The Announcement reviews the legislative and regulatory history of attempts to define internal-use software. Treasury and IRS are requesting comments on the 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.” Commentary on earlier proposed definitions is also welcome as are comments on mixed use software. Finally, comments on whether the new regs should have retroactive effect are requested.

Meanwhile, taxpayers may rely on all of the provisions related to internal-use software contained in the 2001 proposed regulations (66 FR 66362) or upon all of the provisions in TD 8930 (66 FR 280). “For example, taxpayers relying upon the internal-use software rules of TD8930 must also apply the ‘discovery test’ as set forth in TD 8930.” Those regulations provided “research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.”

Comments were requested by 3/2/04.

4. §41 Recordkeeping Pilot Program – Notice 2004-11, 2004-6 IRB 434

Notice 2004-11 explains a pilot program where the IRS and large and mid-size businesses may enter into “research credit recordkeeping agreements” (RCRAs). An RCRA will enable the IRS and an LMSB taxpayer under exam to specify the type and amount of documents that must be kept by the taxpayer in order for the taxpayer to satisfy the §6001 recordkeeping requirements for claiming the research credit. The LMSB Division expects to select 5 – 10 taxpayers for the pilot.

5. §41 and Controlled Groups – PLR 200403043

Prior to acquiring 3 entities, Taxpayer and its controlled group calculated the research credit using the standard formula. T later acquired X, Y and Z which had been part of a group that had been using the AIRC. The IRS ruled that X, Y and Z could calculate the credit using the standard formula once they became part of T (through an asset acquisition). A caveat was included in the ruling: “provided that neither Taxpayer nor any member of its controlled group makes a new

election to determine the credit for increasing research activities under the AIRC rules of §41(c)(4) in a later year.”

6. LMSB Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit

This briefing paper, issued in June 2004, is designed to point out to agents that the “hybrid” approach of capturing costs for computing the research credit is “unauditable.” The 2 commonly used approaches to capturing costs, as noted in the IRS 1995 audit plan for the credit are:

- (1) The project or job cost approach – “directly matches costs with the activities that gave rise to them.
- (2) The cost center or departmental approach - . “tracks costs based on where within the company structure the cost was incurred.” Taxpayers using this approach may also have to segregate out from the cost centers, costs that are not for qualified research.

Many agents have discovered that some taxpayers who say they are using the cost center approach are really using a hybrid approach. “The costs captured under the hybrid approach are generally based on the opinions of company managers delivered years after the fact.” The LMSB Division reports that typically when it sees the hybrid method, it does not find contemporaneous records. In addition, they often find that there is no connection between the “purportedly qualified activities and the allegedly associated costs.” For example, the taxpayer may have captured all wages of employees in a particular department identified on an organizational chart and determined a percentage of the wages that are not for qualified research and the cost center may not match centers used in the taxpayer’s cost accounting system.

The briefing paper reminds agents not to focus just on the cost capturing method, but instead need to be “examining the research credit that was claimed.” The cost capturing technique is important to planning an audit strategy for the credit.

The paper is available at http://www.irs.gov/pub/irs-utl/cost_capturing_approaches_2004-05-24.pdf.

7. Coordinated Issue Paper on §41 and Self-Constructed Supplies

In-house research expenses eligible for the credit include wages and supplies. A few years ago, the IRS raised the question as to what a taxpayer who had self-created supplies could claim as part of in-house expenses. A Coordinated Issue Paper released in June 2004 provides the Service’s answer – at least for audit and litigation purposes. The paper uses an example where a taxpayer used a plant to produce chemicals for use in qualified research. The taxpayer treated its direct and indirect manufacturing costs as supplies for purposes of calculating its in-house research expenses. These costs included depreciation, G&A, employee benefits, T&E, overhead and other indirect expenses.

The IRS held that the costs of producing the chemical supplies for research were not in-house research expenditures. The paper points out that in-house research expenses include wages incurred to employees performing qualified research. Also, the types of expenditures are not ones that qualify under §41, even though they might qualify under §174.

8. Pharmaceutical Industry Research Credit Audit Guidelines

The LMSB Division of the IRS revised and reissued the guidelines on 4/30/04. These materials can be found at <http://www.irs.gov/businesses/corporations/article/0,,id=96915,00.html>.

9. The Future of the Federal Tax Research Tax Credit

Research Credit – Policy Points
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- n** The research credit is intended to:
- §** Encourage businesses to incur costs for research projects despite the reluctance owing to uncertain rewards and significant costs.
- §** Serve as an incentive to stimulate productivity to lead to greater private activity in research.
- §** Address the decline in R&D activities in the U.S. that adversely affect economic growth and competitiveness in world markets.
- §** Encourage taxpayers to conduct research in the U.S.
- n** Rationale for incremental credit - does not reward research that would have been done anyway.

The research tax credit expired on June 30, 2004 and was retroactively extended by P.L. 108-311 on October 4, 2004. The credit now expires after 12/31/05 (that is, it was extended for qualified research expenses paid or incurred before 1/1/06). [P.L. 108-311, §301; Working Families Tax Relief Act of 2004] No other changes were made to the credit.

Other proposals for modification of the research credit include:

- §** President Bush's FY2005 Budget Proposal – would make the research credit permanent. Reasons cited to support this proposal include:¹
 - Economists tend to agree that government intervention can improve overall economic efficiency when it comes to research.
 - The current level of research spending in the US and worldwide is “too little to maximize society's well-being.”
 - U.S. R&D expenditures represent 2.8% of GDP for 2002. While that is greater than in the EU and the average of all countries in the OECD, it is less than that of Japan.
 - While an incremental credit can be complex relative to a flat credit, it is less likely to reward research that would have been undertaken even without a credit.
 - There is evidence that the credit has led to increased research activity in the U.S.
 - §** S. 1637 (Jumpstart Our Business Strength (JOBS) Act) – would (1) extend the credit to 12/31/05, (2) make slight increases in the percentages used to compute the AIRC, (3) add an elective alternative credit equal to 12% of the qualified research expenses over 50% of the prior 3-year average qualified research expenses, and (4) expand the credit with respect to certain collaborative research consortia. This bill was passed in the Senate on 5/11/04. It has many provisions including an FSC/ETI fix, several international provision simplifications, an increase in the §179 expensing amount, a 5-year NOL carryback, a new manufacturer's credit, and several provisions intended to curtail tax shelters including a statutory definition of economic substance.
- Costs: The Joint Committee on Taxation estimates that the cost of extending the credit to 12/31/05 at \$7.56 billion. [<http://www.house.gov/jct/x-45-04.pdf>] The additional modifications in S. 1637 bring the total cost to \$9.77 billion. [<http://www.house.gov/jct/x-36-04.pdf>]
- §** H.R. 428 – calls for a permanent credit.

¹ Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal*, page 359 – 374; available at <http://www.house.gov/jct/s-3-04.pdf>.

- § H.R. 463 and S. 664 - would (1) make the credit permanent, (2) make slight increases in the percentages used to compute the AIRC, and (3) add an elective alternative credit equal to 12% of the qualified research expenses over 50% of the prior 3-year average qualified research expenses.
- § H.R. 1475 (Promote Growth and Jobs in the USA Act of 2003' (the PRO GROW USA Act of 2003)) - would (1) make the credit permanent, (2) make slight increases in the percentages used to compute the AIRC, and (3) add an elective alternative credit equal to 12% of the qualified research expenses over 50% of the prior 3-year average qualified research expenses.

Private and public studies of the research credit are occasionally performed. In April 2004, Washington Council Ernst & Young released a report it prepared for the R&D Credit Coalition, a group of high tech companies.² Some of findings:

- § Between 14,000 and 16,000 companies of all sizes claim the credit, with manufacturing (68.6%), information (16.2%) and service (9.7%) sectors claiming most of the research credit dollars.
- § Companies with \$250 million or more of assets claimed about 80% of the research credit in 2000.
- § Looking at the credit as a percentage of average firm assets, the “value” of the credit is greatest for small firms. For example, companies with \$1000 - \$99,000 in assets claimed a research credit equal to 9.4% of average assets. The equivalent measure for firms with \$250 million or more of assets was 1%.
- § California companies claimed the largest share of research activity with 6,634 firms in 2000, followed by New York with 2,331 firms and Texas with 2,062.

Issues with the Research Credit (as identified by the author):

1. The credit has expired 10 times since it was first enacted in 1981 – should it be made permanent?
2. Should the base period (1984 – 1988) be updated? Should the 50% minimum base rule be repealed?
 - Basically, a credit is generated if current QRE exceeds research intensity (QRE/Gross Receipts) for base period (capped at 16%) applied to average gross receipts for the prior 4 years.
 - However, the base amount cannot be less than 50% of current year QRE. This serves as a cap on the credit (basically limits it to 10% of QRE – which is then further reduced to 6.5% by §280C(c)). This 50% base rule serves to limit the credit for companies with a large increase in QRE over the base amount.

Example: Base amount = \$10
 Current QRE = \$20
 Credit = 20% x \$10 = \$2

Modification: Base amount = \$10

² Cathy Koch, *Supporting Innovation and Economic Growth: The Broad Impact of the R&D Credit*, available at http://www.nam.org/s_nam/bin.asp?CID=155&DID=230921&DOC=FILE.PDF.

Current QRE = \$30

Credit = 20% x \$15 = \$3 (so additional \$10 of current QRE only generated \$1 of credit --- 10%, not 20%)

- A 1995 GAO study found that almost 60% of corporations were subject to the 50% minimum base rule. Query: Is the incremental nature of the credit being carried out if almost 60% of firms, in effect, calculate the research tax credit at 10% of current year QRE?
 - Additional issues with the current base: (1) provides little incentive for companies, such as defense firms, with QRE in the base period that is unrealistically high for them today; (2) doesn't reward companies that have become more efficient in their R&D activities; and (3) incentive is diminished if company has changed its business focus such that it doesn't make sense to devote the same percentage of GR to R&D as in the base period (such as a company that has added new lines of business in the finance area).
3. Is a maximum of 6.5% credit on a subset of §174 expenditures the appropriate incentive? Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research. Query: How much? Also, since many countries are seeking U.S. R&D activities and offer a variety of incentives, what is the appropriate incentive to keep the R&D in the U.S.?
4. The credit cannot be used to reduce AMT (alternative minimum tax) and is not a refundable credit.

10. LAO's Report - *An Overview of California's Research and Development Credit*

California Research Tax Credit

- n** R&T §17052.12 and §23609
- n** California Form 3523
- n** Permanent provision in California law
- n** Similar to federal credit except 15% rate used instead of 20% rate; IRC §41(a)(2) regarding payments to qualified organizations for basic research only applies to corporations and is a 24% rate for corporations (rather than 20% rate for federal credit)
- n** California conforms to federal definition of QRE
- n** Qualified research includes only research performed in California
- n** Gross receipts used for credit calculation only includes receipts from sales delivered or shipped to a purchaser in California ("throwback" sales are not included)

In November 2003, the CA Legislative Analyst's Office issued a report for the Assembly Committee on Revenue & Taxation. The report notes that while there is evidence to support a subsidy at the federal level, the LAO is not aware of any economic evidence to justify a state credit in addition to the federal credit. The cost of the state credit is likely to be high relative to any additional research activity generated. The LAO also points out that direct research spending by the state, such as grants to the UC, may be more effective in achieving the objective of more research activity.

Given all of that, the LAO recommends that the Legislature not expand the research credit any further "unless convincing evidence is sound indicating that this is warranted." In addition, the LAO recommends that the Legislature consider reducing the credit or even phasing it out over time.

The report notes the following commonly cited arguments in favor of a California research credit:

- Social benefits exceed private benefits – research in the state provides spillover benefits to the state.
- Tax credits promote particular economic activity.
- The credit improves the business climate and reduces business costs. This better enables California to compete with other states for research activity.

Arguments against the credit:

- Direct subsidies may be better because credits may be rewarding activity that would have occurred even without the credit.
- Spillover effects do not all occur in California.
- California's research credit is too high.
- On top of the federal credit, the state credit yield relatively small benefits.

The "cost" of the credit in 03/04 is projected to be 5.3% of corporate revenues, compared to about 4% prior to 00/01.

Today, 31 states (including California) offer a research tax credit. Except for Hawaii, the formulas are similar to CA. In Hawaii, all qualified research expenses generate a 20% credit (rather than only qualified research expenses that exceed a base amount).

11. California Research Credit and Unitary Group – *General Motors v. FTB*, B165665 (June 2004)

This case involved tax years 1986 – 1988 and involved 3 main issues, one pertained to the California research credit. GM had a unitary business which had part of its operations in CA. For 1988, GM claimed a research credit of about \$2.8 million. The credit was attributable to Delco – a GM entity with franchise tax liability calculated by GM of about \$6.6 million. GM argued that funds earned by corporations in the unitary group help to fund the research activities that led to the credit. The FTB allowed Delco to reduce its tax of about \$1 million by an equal amount of credit (except for the \$300 minimum tax which could not be reduced by the credit). GM argued that the taxpayer for purposes of the credit is the unitary group and the FTB argued that it was just Delco. The court agreed with the FTB. "Income of the unitary business is determined from the income of all of the corporations that are part of that business, taxes are only imposed on those corporations in the unitary group that are subject to California's tax jurisdiction."

12. When is an Acquired Patent a §197 Intangible - PLR 200416002

Buyer proposed to acquire two patents from Seller which B had been licensing from S for several years. The parties had obtained trademark protection on related to the product and B sold the trademarks to S who licensed them back to B for no additional consideration other than the patent license fee. B and S have agreed to transfer the patents and certain associated trademarks to B for a one-time, up-front fixed payment and annual fixed sum payments for a period of X years and contingent monthly payments over the life of the patents based on usage. B represents that it would have paid the same amount for the patents even if the associated trademarks were not transferred. B asked the IRS to rule that the transfer of the patents and associated trademarks did not constitute the acquisition of assets constituting a trade or business or substantial portion thereof, thus making the patents (and trademarks) 15-year §197 assets.

Generally under §197, the acquisition of intangibles mentioned in §197 will be 15-year assets regardless of how acquired. However, an exception exists for interests in patents and copyrights not acquired in a transaction involving the acquisition of assets that constitute a trade or business or substantial portion thereof. Such patent would instead be amortized under the §167 rules. Reg.

§1.197-2(c)(7) provides that a separately acquired patent includes any incidental and ancillary rights (such as trademarks). Reg. §1.197-2(e) refers to §1060 in determining if assets constitute a trade or business (generally looking at whether the assets constitute an active trade or business under §355 or if goodwill or going concern value attaches to the group of assets). Finally, per §1.197-2(e)(2), a trademark is disregarded if its value is nominal.

The IRS ruled that B's purchase of the patents and trademarks would not constitute the acquisition of assets comprising a trade or business or substantial portion thereof.

Query: Was the ruling needed?

13. Partnerships and §197 – Rev. Rul. 2004-49, 2004-21 IRB 939

“If, pursuant to §1.704-1(b)(2)(iv)(f), a partnership revalues a section 197 intangible that was amortizable in the hands of the partnership, then the §197 anti-churning rules do not apply and the partnership may make reverse §704(c) allocations (including curative and remedial allocations) of amortization to take into account the built-in gain or loss from the revaluation of the intangible. If the revalued section 197 intangible was not amortizable in the hands of the partnership, then the partnership may make remedial, but not traditional or curative, allocations of amortization to take into account the built-in gain or loss from the revaluation of the intangible, provided that such allocations are not limited by §1.197-2(h)(12)(vii)(B).”

14. Telecommunications

- a. **IRS and the 3% Excise Tax** – On 7/2/04, the IRS issued an advance notice of proposed rulemaking (REG-137076-02) seeking comments and suggestions “describing the various technologies, services, and methods of transmission currently available for transmitting data and voice communications and how they should be treated under [Internal Revenue Code] section 4251.” The IRS is considering updating very old regulations to “reflect changes in technology.” The excise taxes apply to local and toll phone service. “Toll telephone service” includes “telephonic quality communication for which there is a toll charge that varies in amount with the distance and elapsed transmission time of each individual communication.”

Soon after the release of the advance notice, some people thought the IRS was planning on taxing VoIP. The IRS subsequently stated that it was not considering applying the 3% excise tax on VoIP.

Some VoIP providers may be collecting the 3% federal excise tax on VoIP. In a 8/4/04 interview, 8X8, Inc.'s CEO noted that it collects the federal excise tax from customers even though it views its services as information services rather than telecom services.³

- b. **The 3% excise tax still exists?** Yes. While there were efforts in Congress to repeal this 100+ year old tax, including H.R. 3916 (106th Congress, 2000) that passed in the house 420-2, nothing was ever enacted. The tax remains and given current budget deficits and probably not serious belief that the tax impedes the growth of the Internet, it is likely to be with us for some time.

³ See <http://www.viodi.com/newsletter/040800/article2.htm>. Per 8X8 Inc.'s 10-K report for 2002, its business is to “develop and market telecommunication technology for Internet Protocol, or IP, telephony and video applications.”

c. Courts Conflicted over What is Taxable under IRC §4251 and 4252

Office Max, Inc. v. U.S., 93 AFTR 2d 2004-1190, 2004-1 USTC ¶70,216, 309 F.Supp2d 984 (ND Ohio 2/13/04) – the court held that the 3% federal excise tax did not apply to long-distance phone services provided by MCI WorldCom and MCI because they did not fall within Section 4251 or 4252. Section 4252(b)(1) defines a toll phone service as a telephonic quality communication for which there is a toll charge which varies in amount with the distance and elapsed transmission time of each individual communication. Office Max argued that the amount it was charged by providers for phone service was never based on the distance. The tax at issue totaled almost \$400,000 over 3 years. The court did not agree with the IRS that the statute was ambiguous so held that there was no need to review the legislative history. The court held that distance and time both had to be met for the service to be subject to the 3% excise tax.

A contrary result was reached in *American Bankers Insurance Group, Inc.*, 93 AFTR2d 2004-1435, 2004-1 USTC ¶70,218, 308 F.Supp2d 1360 (SD Fl 1/29/04). In this case, the court did find the statute ambiguous so reviewed the legislative history which the court viewed as Congress intending to tax all long distance commercial services.

In *Fortis Inc. v. U.S.*, 94 AFTR2d 2004-6005 (SD NY 9/16/04), the court ruled similar to the *Office Max* case that for §4252 to apply, the charges must be based on both time and distance. Similarly, see *National Railroad Passenger Corp v. U.S.*, 94 AFTR 2d 2004-____ (DC DC). In this case, the judge begins the opinion with: “When a defined term in the Internal Revenue Code (“Code”), 26 U.S.C. §1 et seq., fails to keep pace with technological advances and other changes in the commercial world, may the Internal Revenue Service (“IRS”) nonetheless construe the Code to levy a tax arguably envisioned by Congress? This case concerns the proper interpretation and implementation of a federal excise tax on communications services. Finding that Congress meant what it plainly said in 1965, the Court concludes that only Congress, and not the IRS on its own, may update the statutory text. The motion for summary judgment filed by the United States (“IRS”) will be denied and the National Railroad Passenger Corporation's (“Amtrak”) motion for summary judgment will be granted.”

Local and State Relevance: Some state or local jurisdictions use the IRC excise tax definitions in applying telecom taxes. For example, the utility user tax (UUT) imposed by many California cities on telephone services is based on the IRC definitions of §4251 and §4252.

d. IRS and Treasury Concerned – Users under Cents-Per-Minute Plans Will Refuse to Pay 3% Excise Tax

In August 2004, the IRS issued Notice 2004-57 indicating that despite the conflicting decisions of the District Courts, the excise tax remains payable on all taxable communication services (as identified as taxable by the IRS). The IRS and Treasury also issued temporary and proposed regulations on the service provider’s obligation to collect the excise tax when the customer refuses to pay it (TD 9149 and REG 163909; 810/04). “The temporary regulations provide that the collector must report the refusal to pay the tax to the IRS by the due date of the return on which the tax would have been reported but for the refusal to pay. In addition, the temporary regulations provide that, for a person using the alternative method, the separate account cannot be adjusted to reflect a refusal to pay tax for the month unless such refusal has been reported.”

15. International Developments

§ Intangibles and §482 – GlaxoSmithKline filed a petition in Tax Court in April 2004 over the IRS assertion that the US company understated its profits on a patented drug (Zantec) by

almost \$8 billion over 8 years. At issue is the proper profit split under the commensurate with income rule of §482 and how to value payment for trademark and patents over the period of the agreement between the US sub and UK parent. [For more information, see RIA International Taxes Weekly for 4/19/04 and a GrayCary newsletter at [http://www.graycary.com/gcc/GrayCary-C/News--Arti/newsletter/tax/0405/.](http://www.graycary.com/gcc/GrayCary-C/News--Arti/newsletter/tax/0405/)]

- § LMSB Directive on §482 and Intangible Development Costs – On 1/12/04, LMSB issued a directive on stock options and cost sharing arrangements. It notes that Reg. §1.482-7 calls for intangible development costs to be shared among controlled participants in a qualified cost sharing arrangement. An August 2003 amendment to §1.482-7 (TD 9088) clarifies “that the costs associated with stock-based compensation are among the costs that must be shared and to provide rules for measuring such costs. ... The Service continues to maintain its long-standing position that stock-based compensation must be included in the pool of costs to be shared.” See <http://www.irs.gov/pub/irs-utl/costsharingstockoptions.pdf>.
- § LMSB Directive on FSC and §§921-927 Bundle of Rights in Software Issue – On 11/14/03, the LMSB issued an industry directive outlining the Service’s position regarding the 9th Circuit opinion in *Microsoft*: “At this time, litigation in *Microsoft* as to the ‘bundle of rights’ issue is pending. However, considering the change in statute for years after 1997, as well as the Service’s limited resources and intensity of resources necessary to litigate this issue, the Service should generally not assert the ‘bundle of rights’ issue in any open tax year in an attempt to disqualify from the definition of ‘export property’ under 927(a)(2)(B) master copies of computer software licensed solely for the purpose of adaptation, reproduction, and distribution to foreign customers abroad.”
- § H.R. 4520 passed by Congress in October 2004 repeals the FSC/ETI regime, replacing it with a manufacturing incentive (see next). A variety of other international provisions are also included in the legislation, including a temporary 85% dividends received deduction for certain repatriated foreign earnings (proposed new IRC §965).

II. Manufacturing

16. *New Incentive*: The American Jobs Creation Act of 2004 (AJCA) (H.R. 4520; Sec. 102; signed by President Bush on 10/22/04) provides an incentive for manufacturers at new IRC §199. This new deduction replaces the FSC/ETI regime, yet applies to all manufacturers regardless of export activity. Guidance will be needed to interpret the rules and definitions.

This new rule is effective for tax years beginning after 12/31/04. The text of new IRC §199 follows.

§199. Income attributable to domestic production activities.

(a) Allowance of deduction.

(1) In general. There shall be allowed as a deduction an amount equal to 9 percent of the lesser of—

- (A) the qualified production activities income of the taxpayer for the taxable year, or
- (B) taxable income (determined without regard to this section) for the taxable year.

(2) Phasein. In the case of any taxable year beginning after 2004 and before 2010, paragraph (1) and subsections (d)(1) and (d)(6) shall be applied by substituting for the percentage contained therein the transition percentage determined under the following table:

For taxable years	The transition
<u>beginning in:</u>	<u>percentage is:</u>

2005 or 2006	3
2007, 2008, or 2009	6

(b) Deduction limited to wages paid.

- (1) In general. The amount of the deduction allowable under subsection (a) for any taxable year shall not exceed 50 percent of the W-2 wages of the employer for the taxable year.
- (2) W-2 wages. For purposes of paragraph (1), the term “W-2 wages” means the sum of the aggregate amounts the taxpayer is required to include on statements under paragraphs (3) and (8) of section 6051(a) with respect to employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year.
- (3) Acquisitions and dispositions. The Secretary shall provide for the application of this subsection in cases where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.

(c) Qualified production activities income. For purposes of this section—

- (1) In general. The term “qualified production activities income” for any taxable year means an amount equal to the excess (if any) of—
 - (A) the taxpayer's domestic production gross receipts for such taxable year, over
 - (B) the sum of—
 - (i) the cost of goods sold that are allocable to such receipts,
 - (ii) other deductions, expenses, or losses directly allocable to such receipts, and
 - (iii) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.
- (2) Allocation method. The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities.
- (3) Special rules for determining costs.
 - (A) In general. For purposes of determining costs under clause (i) of paragraph (1)(B), any item or service brought into the United States shall be treated as acquired by purchase, and its cost shall be treated as not less than its value immediately after it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts.
 - (B) Exports for further manufacture. In the case of any property described in subparagraph (A) that had been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis under subparagraph (A) shall not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture.
- (4) Domestic production gross receipts.
 - (A) In general. The term “domestic production gross receipts” means the gross receipts of the taxpayer which are derived from—
 - (i) any lease, rental, license, sale, exchange, or other disposition of—

- (I) qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States,
 - (II) any qualified film produced by the taxpayer, or
 - (III) electricity, natural gas, or potable water produced by the taxpayer in the United States,
 - (ii) construction performed in the United States, or
 - (iii) engineering or architectural services performed in the United States for construction projects in the United States.
- (B) Exceptions. Such term shall not include gross receipts of the taxpayer which are derived from—
- (i) the sale of food and beverages prepared by the taxpayer at a retail establishment, and
 - (ii) the transmission or distribution of electricity, natural gas, or potable water.
- (5) Qualifying production property. The term “qualifying production property” means—
- (A) tangible personal property,
 - (B) any computer software, and
 - (C) any property described in section 168(f)(4).
- (6) Qualified film. The term “qualified film” means any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.
- (7) Related persons.
- (A) In general. The term “domestic production gross receipts” shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.
 - (B) Related person. For purposes of subparagraph (A), a person shall be treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).
- (d) Definitions and special rules.
- (1) Application of section to pass-thru entities.
 - (A) In general. In the case of an S corporation, partnership, estate or trust, or other pass-thru entity—
 - (i) subject to the provisions of paragraphs (2) and (3), this section shall be applied at the shareholder, partner, or similar level, and
 - (ii) the Secretary shall prescribe rules for the application of this section, including rules relating to—

- (I) restrictions on the allocation of the deduction to taxpayers at the partner or similar level, and
 - (II) additional reporting requirements.
- (B) Application of wage limitation. Notwithstanding subparagraph (A)(i), for purposes of applying subsection (b), a shareholder, partner, or similar person which is allocated qualified production activities income from an S corporation, partnership, estate, trust, or other pass-thru entity shall also be treated as having been allocated W-2 wages from such entity in an amount equal to the lesser of—
- (i) such persons allocable share of such wages (without regard to this subparagraph), as determined under regulations prescribed by the Secretary, or
 - (ii) 2 times 9 percent of the qualified production activities income allocated to such person for the taxable year.
- (2) Application to individuals. In the case of an individual, subsection (a)(1)(B) shall be applied by substituting “adjusted gross income” for “taxable income”. For purposes of the preceding sentence, adjusted gross income shall be determined—
- (A) after application of sections 86, 135, 137, 219, 221, 222, and 469, and
 - (B) without regard to this section.
- (3) Patrons of agricultural and horticultural cooperatives.
- (A) In general. If any amount described in paragraph (1) or (3) of section 1385(a)—
 - (i) is received by a person from an organization to which part I of subchapter T applies which is engaged—
 - (I) in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or
 - (II) in the marketing of agricultural or horticultural products, and
 - (ii) is allocable to the portion of the qualified production activities income of the organization which, but for this paragraph, would be deductible under subsection (a) by the organization and is designated as such by the organization in a written notice mailed to its patrons during the payment period described in section 1382(d),
 then such person shall be allowed a deduction under subsection (a) with respect to such amount. The taxable income of the organization shall not be reduced under section 1382 by reason of any amount to which the preceding sentence applies.
 - (B) Special rules. For purposes of applying subparagraph (A), in determining the qualified production activities income which would be deductible by the organization under subsection (a) —
 - (i) there shall not be taken into account in computing the organization's taxable income any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions), and
 - (ii) in the case of an organization described in subparagraph (A)(i)(II), the organization shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property

marketed by the organization which its patrons have so manufactured, produced, grown, or extracted.

- (4) Special rule for affiliated groups.
- (A) In general. All members of an expanded affiliated group shall be treated as a single corporation for purposes of this section.
 - (B) Expanded affiliated group. For purposes of this section, the term “expanded affiliated group” means an affiliated group as defined in section 1504(a), determined—
 - (i) by substituting “50 percent” for “80 percent” each place it appears, and
 - (ii) without regard to paragraphs (2) and (4) of section 1504(b).
 - (C) Allocation of deduction. Except as provided in regulations, the deduction under subsection (a) shall be allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of qualified production activities income.
- (5) Trade or business requirement. This section shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business.
- (6) Coordination with minimum tax. The deduction under this section shall be allowed for purposes of the tax imposed by section 55; except that for purposes of section 55, the deduction under subsection (a) shall be 9 percent of the lesser of—
- (A) qualified production activities income (determined without regard to part IV of subchapter A), or
 - (B) alternative minimum taxable income (determined without regard to this section) for the taxable year.

In the case of an individual, subparagraph (B) shall be applied by substituting “adjusted gross income” for “alternative minimum taxable income”. For purposes of the preceding sentence, adjusted gross income shall be determined in the same manner as provided in paragraph (2).

- (7) Regulations. The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section.

III. Selling and Using IP

Selling Considerations for High Tech

- n** Can revenue on prepaid contracts, such as software maintenance contracts be deferred?
- n** Does taxpayer have nexus in any state where it has customers? Rules vary for income versus sales tax and if taxpayer selling tangible vs. intangibles/services.
- n** Does taxpayer owe minimum tax in the state?
- n** E-commerce – some uncertainties exist and governments are working to resolve them.

17. Reporting Revenue from Prepayments

As stated in Notice 2002-79, the IRS intended to improve the functioning of Rev. Proc. 71-21 by eliminating some of the problem areas. After receiving guidance from the public, in May 2004, the IRS issued Rev. Proc. 2004-34 (2004-22 IRB 991) to replace Rev. Proc. 71-21.

Key similarities with Rev. Proc. 71-21:

- o No deferral of income beyond the next succeeding tax year. [But Rev. Proc. 2004-34 has a special rule for certain short years that are the next succeeding tax year, in which case the taxpayer may recognize the income required for that short year (per 5.02(3)) and balance of revenue in subsequent year.]
- o An advance payment does not include: rent, insurance premiums, payments with respect to financial instruments, payments with respect to service warranty contracts for which the taxpayer uses the method provided in Rev. Proc. 97-38, payments with respect to warranty and guaranty contracts under which a third party is the primary obligor, payments subject to §871(a), 881, 1441 and 1442

Key differences from Rev. Proc 71-21:

- o Applies to more than just pure services. Advance payment can be for:
 - § Services
 - § Sale of goods (provided 1.451-5 isn't applied to the goods)
 - § Use, including by license or lease, of intellectual property (copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights such as franchise rights and arena naming rights)
 - § Occupancy or use of property if the occupancy or use is ancillary to the provision of services (such as booth space at a trade show) – use must be ancillary to the provision of services to the property user
 - § Sale, lease, or license of computer software
 - § Guaranty or warranty contracts ancillary to an item or items described above
 - § Subscriptions (if no election under §455 applies), whether the item provided is tangible or intangible
 - § Memberships in an organization (unless an election under §456 is in effect
 - § Any combination of items described above

- Does not apply to credit card fees (some cases had held that Rev. Proc. 71-21 would apply where services were clearly provided). Instead, see Rev. Rul. 2004-52, Rev. Proc. 2004-32 and Rev. Proc. 2004-33.
- The “tracking” system/theory is different now. Under Rev. Proc. 71-21, you needed to identify what the tax reporting system would be for the 2 years of reporting and revenue would be accelerated if a greater amount was reported in financial statements. Under Rev. Proc. 2004-34, financial statement reporting for the year of receipt governs in that the taxpayer is to report the same amount for tax as either reported in the applicable financial statement, or if there is no applicable financial statement (or the taxpayer is unable to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the tax year of receipt), taxpayer includes the payment in gross income in the year of receipt to the extent earned in that tax year (ok to use a statistical basis, ratable reporting or a method the IRS approves).

Also, is okay if the contract term extends beyond the end of the next tax year, taxpayer just doesn't get deferral beyond end of next tax year (unless short tax year rule applies).

Example 2: X provides dance lessons using 2-year contracts for 96 lessons. X provides 8 lessons in 2004, 48 in 2005 and 40 in 2006. Financial statements show 1/12 of advance payments in 2004, 6/12 in 2005 and 5/12 in 2006. For tax, X reports 1/12 in 2004 and 11/12 in 2005.

- Special rule that allows a short year following the year of receipt to not be considered the only subsequent tax year (if short year is 92 days or less). Therefore, can get a longer spread – not disadvantaged when a have a short year.
- Specified rules for allocating revenues of an advance payment where only part of the advance payment falls under Rev. Proc. 2004-34 or portions fall under more than one type of advance payment and reporting in financial statements is different for each (5.02(4)).
- TD 9135 (7/8/04) issued to change §1.61-8. Prior to change, regulation stated that unless §467 provided otherwise, advance rentals are to be reported when received. After the change, an exception is added for published guidance (such as RP 2004-34).

Basic requirements:

- Have an advance payment (4.01)
- Have an “applicable financial statement” (4.06) so taxpayer knows what portion of the revenue was reported when (particularly, how much was reported in first year). Or, if no applicable financial statement, must know the extent to which advance payments are *earned* in the tax year of receipt. Then, balance of the advance payment is reported in subsequent year unless the special rule for short tax years applies.

Note: It is not enough to just have an advance payment and an applicable financial statement. For example, consider Example 7 in the Revenue Procedure: A hair styling salon received advance payments for gift cards to be redeemed at the salon for services or products at the face value of the gift card. The cards have no expiration date. In its applicable financial statement, salon recognizes advance payments for gift cards in revenues when redeemed. The salon cannot determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the year of receipt. And, the salon does not determine under a basis described in 5.02(3)(b) the extent

to which payments are *earned* for the tax year of receipt. So, the salon may not use the Deferral Method.

Software Example (#19):

- § P sells and licenses off-the-shelf SW and provides customer support.
- § 7/1/04 receives advance payment for 2-year SW maintenance contract to provide updates (if any) and telephone support
- § Applicable financial statement – P reports $\frac{1}{4}$ in 2004, $\frac{1}{2}$ in 2005 and $\frac{1}{4}$ in 2006
- § Tax – P reports $\frac{1}{4}$ in 2004 and $\frac{3}{4}$ in 2005

Effective for tax years ending on or after May 6, 2004.

See Section 8.06 for transition rules. Basically, a taxpayer using Rev. Proc. 71-21 would file Form 3115 under Rev. Proc. 2002-9.

18. State Tax Law Updates

- a. Sales/Use Tax in Wisconsin – Custom vs. Prewritten Software: State sales tax laws differ on what is subject to tax, how they define tangible personal property and whether different types of software are taxed differently. In Wisconsin, tangible personal property includes computer programs except custom computer programs. “Custom” software is defined as utility and application software that meets special processing needs of the customer. It is a facts and circumstances determination with the following items considered (but not an exhaustive list).
 - Whether the vendor or consultant engage in significant presale consultation and analysis.
 - Who loads the software onto the customer’s machine (if the vendor loads it, it looks more like custom software).
 - Whether the software requires substantial training of customer’s employees and substantial written documentation.
 - Whether enhancement and maintenance support by the vendor is required for continued usefulness of the software.
 - Whether the software costs \$10,000 or less (in which case it is presumed not to be custom).
 - Whether the software is a basic operational or prewritten program (in which case it is not likely to be custom).
 - Where an existing program is modified, was it a significant modification.

The taxpayer had investigated what software to acquire to meet its complex needs. It used consultants to help in the process and an SAP package was selected that needed extensive modification and some new pieces of code to meet taxpayer’s needs. Total costs were over \$23 million with just \$5.2 million of that for the basic SAP package acquired. Over 3,000 modifications were made to the basic package.

SAP was audited by Wisconsin and the result was that SAP’s sales of the packaged software were found to be subject to sales and use tax as a non-custom program.

The Wisconsin Tax Appeals Commission concluded that the taxpayer’s expenditures were for custom software. It found that the first 4 factors about were quantitative and led to the conclusion that the amount of effort involved to make the SAP package meet taxpayer’s

needs indicated it was potentially a custom (not a prewritten) package. The Commission stated that the “more pre-sale planning, the more testing, the more training, the more written documentation, the more enhancement, and the more maintenance, then the more likely the software is custom software.” [*Menasha Corp v. Wisconsin Dept. of Revenue*, Docket No. 01-S-72, 12/03]

Queries: (1) How should Menasha have treated the costs of getting the SAP package ready for use – as installation costs (basis of the software), similar to §174 R&D expenditures, and are any eligible for the research credit (assuming they are truly R&D under §174, rather than only under Rev. Proc. 2000-50)? (2) Once a state stretches the definition of tangible personal property to include off-the-shelf software, why not also bring in custom software for purposes of simplicity? Is a custom package really services rather than a final product?

- b. Franchise Tax and Apportionment for Software Sales in Texas: Ruling No. 200402483L provides that for a sale of tangible personal property that includes a component of software, is considered receipt for the sale of TPP, unless the software: “(1) is licensed separately from the TPP; (2) is priced separately from the TPP; (3) can be installed by the purchases; and (4) is not all or part of the operating system of the TPP.” If all 4 criteria are met, the revenue from the software may be apportioned to the location of the payor.
- c. Sales/Use Tax Nexus and Third Party Service Providers: Dell Catalog Sales was found not to have nexus in Connecticut from its relationship with BancTec which provided services to Dell’s customers. Dell Catalog has not presence in the state. Its customers may purchase a service contract from BancTec. Dell typically sold the service contract at the time it sold the computer and contracts could not be purchased from Dell without also buying a computer. About 75% of customers also purchased a service contract. Dell collected sales tax on the service contract, but not on the computer and remitted the tax to the state. The “the terms of the Service Contract Sales Brokerage Agreements provided that Dell Catalog Sales would act as BancTec’s agent and broker in marketing BancTec’s service contracts, and Dell entities would provide certain technical assistance to BancTec in connection with BancTec’s service contracts, in exchange for the contract commission.” Dell received about 90% of the service contract revenue because it provided the bulk of the services via the phone through Dell Tech Support outside of the state. The court noted that this situation indicated that “BancTec’s effort in going on-site in Connecticut to service the consumer’s computer had to be minimal.”

Dell Catalog was registered to do business in Texas, Florida, Kentucky and Nevada, but the Connecticut Tax Commissioner registered Dell (involuntarily) to do business in Connecticut. The Commissioner argued, based on *Scripto* (362 US 207 (1960)), that Dell owes use tax on computer sales in the state because BancTec is its representative in the state. The court noted that the Commissioner’s position was also supported by the Multistate Tax Commission’s (MTC) Nexus Program Bulletin 95-1.

The court noted: “Although it appears that BancTec was operating in Connecticut on Dell’s behalf, in fact the parties have stipulated that BancTec was an independent computer service provider throughout the United States, and that on-site service was performed solely by BancTec or its subcontractors. (Joint Stipulation of Facts, ¶¶35-36.) his stipulation of the parties negates the claim of the Commissioner that BancTec was the agent of the plaintiff in Connecticut. By stipulating that BancTec was an independent service provider, the Commissioner acknowledged that Dell had no right to direct and control the work of BancTec. *Beckenstein v. Potter & Carrier, Inc.*, 191 Conn. 120 , 132-33, 464 A.2d 6 (1983)

. We also find credible the testimony of Michael Burns, vice president of sales and marketing of BancTec that servicing computers was their expertise and that Dell did not control or interfere in BancTec's dealings with the customer. This lack of control by Dell substantiates the stipulation of the parties that BancTec was not an agent for Dell.”

Further, “We note that Dell provides service to the consumer under the terms of the service contract only by telephone in Texas, and BancTec, for its part, performs only on-site service to the consumer in Connecticut. We further note that Dell markets and sells the service contract to its own customer at the time that it sells the customer a computer; that Dell sets the price of the contract to the consumer; that Dell earns a substantial portion of the cost of the contract; and that Dell performs a substantial part of the service required under the terms of the service contract. Although Dell's name does not appear on the service contract as a contracting party, Dell is an integral part and a major ingredient in the performance of the contract. Cases dealing with the issue of whether the use of independent service representatives provides the in-state physical contacts required to establish nexus by an out-of state seller focus on the extent of the activities of the in-state independent service representative. In *Scripto*, ten independent service representatives conducting continuous local solicitation in Florida and forwarding the orders to the out-of-state seller for acceptance of the orders was sufficient nexus for the state of Florida to require the out-of- state seller to collect a state use tax upon the sale of the goods shipped to customers in Florida. *Scripto v. Carson*, supra, 362 U.S. 211- 212 . In *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 251 , 107 S. Ct. 2810 (1987) , the U.S. Supreme Court held that having resident sales representatives in the taxing jurisdiction to establish and maintain the seller's market constituted physical contacts that established a nexus sufficient to impose a business and occupation tax on sales upon the out-of-state seller. The Tyler court stated: “[T]he crucial factor governing nexus is whether the activities performed [in Washington] on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.” Id., 250-251. The Tyler case was a direct tax case, not a sales and use tax case, but we see the principle of nexus associated with the extent of the in-state activity to apply with equal force to cases involving sales and use taxes.” The court also discussed *In re the Appeal of InterCard*, 270 Kan. 346 , 14 P.3d 1111 (2000), where the court found 11 visits to the state to not create a substantial nexus in the state.

Thus, the court found that Dell Catalog had no sales tax nexus in the state. “The missing ingredient in determining whether BancTec's on-site service established nexus in Connecticut as a representative of Dell would be the frequency, if any, of the number of on-site service calls. [*Dell Catalog Sales v. Commissioner, Department of Revenue Services*, 834 A2d 812 48 Conn Supp 170 (July 2003)]

Similarly, see *State v. Dell Catalog Sales, L.P.*, La. District Ct., No. 456,807 (May 2004), where the court did not find that an agency relationship existed between Dell and BancTec and that BancTec's services were provided on behalf of customer who purchased a contract and not on behalf of Dell Catalog.

- d. P.L. 86-272 and Minimum Corporate Tax: Taxpayer is a North Carolina company that uses independent contractors to solicit orders in New Jersey. T operated within the protections of P.L. 86-272 so as not to owe income tax in NJ. The NJ Division of Taxation sent a nexus questionnaire to T and concluded that T was subject to income tax. T filed a protest and the tax agency ended up assessing the state's minimum tax of \$200 for the years at issue. The NJ tax court concluded that T had nexus in the state under both Due Process and Commerce Clause analyses, relying on *Quill*, 504 U.S. 298 (1992), and *Scripto*, 362 US 207 (1960).

The court further held that the minimum tax was not an income tax subject to the protections of P.L. 86-272. “In this case, the Director is using the activity of the Home Impressions in New Jersey as a reporting requirement under the Act and not as a means of calculating the amount of the minimum flat tax due. Accordingly, the court finds that the protections afforded by Pub. L. 86-272 do not protect foreign corporations from the minimum flat tax imposed under the Act since the minimum tax is not based on net income.” [*Home Impressions, Inc., Plaintiff, v. Director, Division of Taxation, Defendant.*, 000099-2003 (June 2004).]

- e. California Attempt to Clarify Nexus: AB 2061 would “enact the Business Activity Tax Simplification Act pursuant to which no person, as defined, would be subject to a business activity tax, as defined, imposed by this state unless that person has a physical presence in this state during the taxable period with respect to which the tax is imposed.”

19. State Efforts to Streamline Sales and Use Tax Rules

§ Background on the Streamlined Sales Tax Project (SSTP)

This project, begun in 2000, is designed to simplify and modernize state sales and use tax systems in order to reduce the burden on companies of collecting the taxes. There are 42 states and the District of Columbia participating in the project. The model tax agreement of the SSTP contains uniform definitions, allowance of one state rate per state and a second state rate in limited circumstances for food and drugs, one local rate for each local jurisdiction, state level tax administration for the state and local taxes, uniform sourcing rules, uniform audit procedures and state funding of the technological models provided for in the agreement.

Per an April 2004 project summary: “Sellers who do not have a physical presence or ‘nexus’ are not required to collect sales and use taxes unless Congress chooses to require collection from all sellers for all types of commerce. Sellers without a physical presence can volunteer to collect under the proposed simplifications. Registration by sellers to voluntarily collect sales and use taxes will not infer that the business must pay business activity taxes, such as the corporate franchise or income tax.”

[<http://www.streamlinedsalestax.org/execsum0404%20.pdf>]

To be a member state must conform its sales/use tax rules to that called for in the model agreement and have a “certificate of compliance” to be part of the interstate Agreement. There will be a Governing Board made up of a representative from each member state. The board will interpret the Agreement, amend it and issue resolutions.

As of 11/12/02, 30 states plus DC approved the interstate Agreement. As of 4/04, 20 states have enacted all or part of the conforming legislation – the Streamlined Sales and Use Tax Agreement (SSUTA). For more information, see <http://www.streamlinedsalestax.org>.

States may need to make significant changes in their existing sales tax rules to be part of the Agreement. Also, it is not clear whether Congress will act to, in effect, repeal the *Quill* decision for adopting states so that the states may enforce collection of use tax by remote vendors. The SSTP’s list of states and their role/status in the SSTP is at <http://www.streamlinedsalestax.org/statestatus.pdf>. It notes that the Agreement becomes effective once at least 10 states representing 20% of the population of states imposing a sales tax have enacted appropriate legislation. It also notes that compliance by remote vendors is voluntary under the agreement until Congress or the U.S. Supreme Court indicates otherwise.

There is also a list of states and the status of their SSTP legislation at the Equipment Leasing Association (ELA) website at <http://www.elaonline.com/govrelations/state/streamometer/>. Most of the states that have enacted appropriate legislation (although no legislation has been certified yet) are small, such as Nevada, Utah, North Dakota, West Virginia and Vermont which each have less than 1% of the US population (less the 4 states without a sales tax – Delaware, Montana, New Hampshire and Oregon). However, if all of the states indicated as having enacted complete SSTP legislation were certified, it would be about 23% of the population and thus, a Governing Board would come into existence.

§ Will Congress Help the SSTP Efforts? A few bills have been introduced to enable states that adopt the SSTP legislation and once the number of states meets the level for a Governing Board to exist, to allow such states to also collect use tax from remote vendors. H.R. 3184 is such a bill that also includes an exemption for small remote vendors – those with gross remote taxable sales under \$5 million in the preceding year. The ability to collect from remote vendors also requires that the state provide reasonable compensation to sellers for collecting the sales and use tax for the state. H.R. 3184 also lists the minimum simplification provisions that must be included in the SSTP Agreement. H.R. 3184 also provides that nothing in the proposal is intended to add or expand a state’s ability to assess other tax obligations on vendors. S. 1736 is the companion bill in the Senate. The bills are still in committee and have few sponsors.

§ “Preliminary Analysis of California Issues”⁴

The “Board of Governance,” created by SB 157 in 2003, represents CA in the SSTP meetings and must report quarterly to the legislative tax-writing committees. The BG’s April 2004 report listed the following issues for CA under the SSTP:

- The Governing Board created by the model act may draft rules and procedures. It may also resolve issues. This would conflict with the role of the CA legislature and BOE because if they wavered from the Agreement, they could be expelled from membership.
- CA’s compliance with the model act “may require significant revisions” to its sales and use tax law. Analysis is needed to determine if such changes would result in revenue increases or decreases.
- The model act requires destination-based sourcing. This is not the case today for property that is not delivered to the customer at the seller’s business location. There could be negative impacts to some local taxing jurisdictions.
- Under the model act, the tax base is to be the same at the state and local levels. This is not true today for retail transfers of motor vehicles, aircraft, watercraft, modular homes, manufactured homes and mobile homes.
- The model act requires a state to provide compensation to certified service providers and sellers for collecting and reporting sales and use tax. CA does not currently do this.

§ Selected State Activity Related to the SSTP

- Utah delayed its implementation of the model act one year – until 7/1/05 so that there could be a study on the effects to taxpayers and recommendations made on how to mitigate adverse impacts of the changes.

⁴ Board of Governance (created by SB 157), “Streamlined Sales Tax Project – A Report to the Legislature on the Streamlined Sales Tax Project,” April 30, 2004; available at <http://www.boe.ca.gov/pdf/1Q04SSTPLegRptFinal42204.pdf>.

- The Iowa Revenue Department issued a notice to all sales tax permit holders letting them know that there would be relaxed enforcement of the new sourcing rules from the effective date of 7/1/04 to the end of the year. No penalties will be assessed for errors during the 6-month period provided honest efforts were made to comply.

§ Arguments in Favor of the SSTP⁵

- The National Retail Federation has stated that the SSTP provides certainty and simplification to retailers. It also provides equal collection equal collection responsibility for sellers and is a “careful balance of both sovereignty and simplification.” Uniform definitions and administration procedures provide simplification for retailers.⁶
- It provides for compensation to vendors to partially compensate them for collecting the tax.
- It provides technological solutions to simplify the assessment and collection process.

§ Arguments Against the SSTP⁷

- Uncollected use tax is not as high as some estimates have indicated. States can do more to collect use tax and more online retailers are establishing a physical presence in more states because consumers want this.
- “Congress should not grant states the right to tax Internet sales unless they have first eliminated protectionist laws and regulations that discriminate against e-commerce, or unless they can make a clear and compelling argument that discriminatory laws or regulations are required for consumer protection.” Examples of protectionist laws include not letting patients have a copy of their lens prescription so they cannot get glasses online, prohibitions against marketing used cars on the web, and rules prohibiting shipping of wine into a state. The Progressive Policy Institute estimates that these protectionist rules result in consumers paying \$22 billion more per year on goods and services than otherwise required.⁸
- Problems with the Model Act, such as:
 - § Each member state gets just one vote, so California, with its large population and market, will have a small voice in interpreting and changing the model act.
 - § A major simplification – one rate per state, is missing because local jurisdictions are allowed to set their own rate.
 - § It does not address the problem that led to the *Quill* decision – states wanting remote vendors to collect sales tax. The SSTP hopes that Congress will step in and solve this problem for adopting states, but there is no guarantee of this. However, if Congress steps in, such as with H.R. 3184 (discussed above), that exempts retailers with \$5 million or less of remote taxable sales, states will likely have a

⁵ For materials submitted for a 10/1/03 hearing on the SSTP before the House Judiciary Committee, see <http://www.house.gov/judiciary/89635.PDF>.

⁶ Maureen B. Riehl, National Retail Federation, testimony before the 10/1/03 House judiciary Committee, pages 12 - 17, at <http://www.house.gov/judiciary/89635.PDF>.

⁷ For materials submitted for a 10/1/03 hearing on the SSTP before the House Judiciary Committee, see <http://www.house.gov/judiciary/89635.PDF>.

⁸ Robert D. Atkinson, “Leveling the E-Commerce Playing Field,” 6/30/03; available at <http://www.ppionline.org/>.

reduced incentive to adopt the SSUTA. Also, it is arguable that Congress suggesting such an exemption indicates that the SSUTA is not simple enough.

- § Many states, including California, will need to change their sourcing rules which for many retailers will be a more complicated system. For example, in California, if a retailer has only one business location, it only has to apply the rate of the city in which it resides. Under the model act, it would have to apply the rates of the cities where goods were delivered (destination approach rather than origin approach). If only a single rate were allowed in a state though, this problem would be lessened, although the retailers would still be required to note where goods were delivered so the state could be sure the collected tax went to the correct local jurisdiction. However, there would be winners and losers among local jurisdictions under the new tax sourcing/allocation scheme, with no transition rule provided.
- § Exemptions are still allowed if it is a separately defined category under the Act SSUTA §316). Thus, retailers will still need to track exemptions by state.
- § Governor Bill Owens of Colorado has spoken out against the SSTP and the NCSL has argued that his arguments are “filled with misstatements and misconceptions.” The arguments and counterarguments raised by Governor Owens and the NCSL provide a good illustration of some of the challenges of a model act to replace 46 diverse sets of tax rules and items that need to be debated by legislatures. For example, Governor Owens states that the SSTP is not revenue neutral while the NCSL states that each state has the authority to make their participation revenue neutral. That is, a state can adjust its sales tax rate or other taxes to maintain revenue neutrality and it could help cover the cost of required vendor compensation through other taxes or collections from remote sellers (however, the SSTP does not require remote sellers to collect use tax).⁹

20. E-Commerce Updates

- § Federal Internet Tax Moratorium: The Internet Tax Freedom Act moratorium expired on November 1, 2003. Several bills have been introduced to extend it, expand it or tighten it.

Moratorium Review

- n Federal Internet Tax Freedom Act (ITFA, P.L. 105-277, 10/21/98) imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) on state and local taxes on Internet access, unless such tax was generally imposed and actually enforced before 10/1/98.
- n Extended to 11/1/03 (P.L. 107-75; 11/28/01).
- n Moratorium also applies to multiple or discriminatory taxes on e-commerce.
- n ITFA preserves state and local taxing authority to the extent the particular tax is not covered under the moratorium (so California can still make consumers pay use tax on Amazon.com purchases).

S. 150 extends the moratorium and grandfather provision retroactively until 11/1/07. Other provisions include:

⁹ Governor Owens’ arguments can be found at pages 4 to 12 of the 10/1/03 House Judiciary Committee hearing on the SSTP at <http://www.house.gov/judiciary/89635.PDF>, and the NCSL counterarguments can be found at http://www.ncsl.org/standcomm/sctech/tax_Misconceptions.htm.

- § A provision is added that the term `Internet access service' “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.”
- § VOIP – the bill adds: “Nothing in this Act shall be construed to affect the imposition of tax on a charge for voice or similar service utilizing Internet Protocol or any successor protocol. This section shall not apply to any services that are incidental to Internet access, such as voice-capable e-mail or instant messaging.”
- § Calls for the GAO to conduct a study due 11/1/05 of the impact of the moratorium on state and local governments and broadband deployment.

S. 150 passed in the Senate (97-3) on 4/29/04.

H.R. 49, calling for a permanent moratorium and repeal of the grandfather provision passed in the House in 9/03.

S. 2084 calls for (1) a 2-year extension, (2) adding “The term `Internet access service' does not include telecommunications services, except to the extent such services are purchased, used, or sold by an Internet access provider to connect a purchaser of Internet access to the Internet access provider,” and (3) makes modifications to the grandfather clause. Senator Feinstein is a co-sponsor.

S. 2348 would extend the current moratorium until June 1, 2005. Senator Feinstein is a co-sponsor.

§ CA Internet Tax Moratorium: The moratorium expired January 1, 2004. AB 1791 would extend it to January 1, 2010.

§ OECD Developments

- (1) Tax Treaties: In November 2003, the Technical Advisory Group (TAG) established in 1999 on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits issued its draft report. The draft covers the emergence of new business models, current treaty rules for taxing business profits, relevant tax principles, alternatives to the current rules, conclusions and examples. The TAG concluded that major modifications were not appropriate (at least at this time) particularly in light of the fact that e-commerce does not seem to have resulted in “any significant decrease to the tax revenues of capital importing countries.” The TAG also notes that fundamental changes “should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that have been suggested so far appears to meet that condition.” Such a change would “create difficult transition rules.” Finally, the TAG noted that the effect of the new business models on direct tax revenues should continue to be monitored and further recommendations could be made after the TAG reviews comments received on the draft. See <http://www.oecd.org/dataoecd/2/38/20655083.pdf>.
- (2) Further work by OECD: Additional reports are likely to be issued in 2004 on possible changes or recommendations for change to treaty provisions on permanent establishment (PE), effective place of management, business profits, consumption tax matters and tax administration. See <http://www.oecd.org/taxation> and <http://www.oecd.org/dataoecd/45/19/20499630.pdf>.

IV. Donating IP

21. Charitable Contributions of IP - Notice 2004-7, 2004-3 IRB 310

Due to specific concerns with certain donations of intellectual property, the IRS issued this notice to alert taxpayers of possible penalties under §6662 and promoters and appraisers of possible penalties under §§6700, 6701 and 6694. The concerns stem from the IRS becoming aware of “purported charitable contributions of intellectual property in which one or more of the following issues are present: 1) transfer of a nondeductible partial interest in intellectual property; 2) the taxpayer’s expectation or receipt of a benefit in exchange for the transfer; 3) inadequate substantiation of the contribution; and 4) overvaluation of the intellectual property transferred.”

The Notice reviews the rules on what makes something a charitable contribution under §170 and refers to examples in Rev. Rul. 2003-28, 2003-11 IRB 594. Key reminders include: a) generally no charitable contribution deduction is allowed when less than the taxpayer’s entire interest in the property is transferred, b) there must be evidence an intent to make a gift – a transfer without receipt of adequate consideration and the taxpayer knowing at the time of transfer that the value of it gave was greater than what it received, c) the taxpayer has the burden to show that a transfer was a charitable contribution, d) the contribution must be substantiated as required by §170(a)(1) and (f)(8) and §1.170A-13, and (e) the contribution must be properly valued. “For example, the fair market value of a patent must be determined after taking into account, among other factors: (1) whether the patented technology has been made obsolete by other technology; (2) any restrictions on the donee’s use of, or ability to transfer, the patented technology (see Rev. Rul. 2003-28, Situation 3); and (3) the length of time remaining before the patent’s expiration.”

22. Special Rule for Contributions of Technology for Educational Purposes

The enhanced charitable contribution deduction of §170(e)(6) for donations of computer technology and equipment for educational purposes was extended. Instead of the benefit terminating for tax years beginning after 12/31/03, it now terminates for tax years beginning after 12/31/05. [P.L. 108-311, §306; Working Families Tax Relief Act of 2004]

23. Limitation on Deduction for Donations of Patents

The American Jobs Creation Act of 2004 (AJCA) (H.R. 4520; signed by President Bush on 10/22/04) limits the deduction for patents and other specified intangibles by having them fall under the limitation of §170(e). Under this provision, the fair market value of the donated intangible must be reduced by the sum of the amount that would not have been long-term capital gain if the property had instead been sold, plus the amount of long-term capital gain that would have resulted from sale of the item. Thus, the deduction is limited to the lesser of either FMV or basis of the patent. This new rule applies to “patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property.”

The AJCA also adds new §170(m) effective for contributions made after 6/3/04. The text follows.

(m) Certain donee income from intellectual property treated as an additional charitable contribution.

(1) Treatment as additional contribution. In the case of a taxpayer who makes a qualified intellectual property contribution, the deduction allowed under subsection (a) for each taxable year of the taxpayer ending on or after the date of such contribution shall be increased (subject to the limitations under subsection (b)) by the applicable percentage of

qualified donee income with respect to such contribution which is properly allocable to such year under this subsection.

- (2) Reduction in additional deductions to extent of \ initial deduction. With respect to any qualified intellectual property contribution, the deduction allowed under subsection (a) shall be increased under paragraph (1) only to the extent that the aggregate amount of such increases with respect to such contribution exceed the amount allowed as a deduction under subsection (a) with respect to such contribution determined without regard to this subsection.
- (3) Qualified donee income. For purposes of this subsection, the term “qualified donee income” means any net income received by or accrued to the donee which is properly allocable to the qualified intellectual property.
- (4) Allocation of qualified donee in- 19 come to taxable years of donor. For purposes of this subsection, qualified donee income shall be treated as properly allocable to a taxable year of the donor if such income is received by or accrued to the donee for the taxable year of the donee which ends within or with such taxable year of the donor.
- (5) 10-year limitation. Income shall not be treated as properly allocable to qualified intellectual property for purposes of this subsection if such income is received by or accrued to the donee after the 10-year period beginning on the date of the contribution of such property.
- (6) Benefit limited to life of intellectual property. Income shall not be treated as properly allocable to qualified intellectual property for purposes of this subsection if such income is received by or accrued to the donee after the expiration of the legal life of such property.
- (7) Applicable percentage. For purposes of this subsection, the term “applicable percentage” means the percentage determined under the following table which corresponds to a taxable year of the donor ending on or after the date of the qualified intellectual property contribution:

Taxable Year of Donor Ending on or After Applicable Date of Contribution:	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.

- (8) Qualified intellectual property contribution. For purposes of this subsection, the term “qualified intellectual property contribution” means any charitable contribution of qualified intellectual property—
 - (A) the amount of which taken into account under this section is reduced by reason of subsection (e)(1), and
 - (B) with respect to which the donor informs the donee at the time of such contribution that the donor intends to treat such contribution as a qualified intellectual property contribution for purposes of this subsection and section 6050L.

- (9) Qualified intellectual property. For purposes of this subsection, the term “qualified intellectual property” means property described in subsection (e)(1)(B)(iii) (other than property contributed to or for the use of an organization described in subsection (e)(1)(B)(ii)).
- (10) Other special rules.
- (A) Application of limitations on charitable contributions. Any increase under this subsection of the deduction provided under subsection (a) shall be treated for purposes of subsection (b) as a deduction which is attributable to a charitable contribution to the donee to which such increase relates.
- (B) Net income determined by donee. The net income taken into account under paragraph (3) shall not exceed the amount of such income reported under section 6050L(b)(1) .
- (C) Deduction limited to 12 taxable years. Except as may be provided under subparagraph (D)(i), this subsection shall not apply with respect to any qualified intellectual property contribution for any taxable year of the donor after the 12th taxable year of the donor which ends on or after the date of such contribution.
- (D) Regulations. The Secretary may issue regulations or other guidance to carry out the purposes of this subsection, including regulations or guidance—
- (i) modifying the application of this subsection in the case of a donor or donee with a short taxable year, and
- (ii) providing for the determination of an amount to be treated as net income of the donee which is properly allocable to qualified intellectual property in the case of a donee who uses such property to further a purpose or function constituting the basis of the donee's exemption under section 501 (or, in the case of a governmental unit, any purpose described in section 170(c)) and does not possess a right to receive any payment from a third party with respect to such property.

V. Compensating Employees

24. IRS Initiative on Executive Compensation

In December 2003, the Large and Mid-sized Business (LMSB) Division announced (actually previously announced during the November 2003 IRS's Tax Talk Today CE program) that one of its compliance efforts would be executive compensation. This announcement stated:

“LMSB is taking a leading role in coordinating, developing and implementing a strategy to identify and address compliance issues in the area of executive compensation. LMSB is currently reviewing executive compensation issues as part of the examinations of 24 corporation tax filings. Expansion of this activity will be commensurate with the results of those cases.

The size or dollar value of executive compensation is not under the jurisdiction of federal tax administration; it is a corporate governance matter that is the responsibility of the employer's board of directors or other governing body. There are, however, multi-faceted tax implications for all forms of executive compensation: income and employment tax issues for the employers who pay the compensation and the executive employees who receive it. In addition to the increasing use of non-cash compensation, the use of partnerships and trusts (both domestic and offshore) in the handling of compensation is also increasing. These factors add considerable complexity in determining current and future year tax liabilities for executives and their employers.

Executive compensation has evolved dramatically in recent years, in creativity, complexity and dollar value. Stock options, deferred compensation, fringe benefits and other “non-cash”

alternative forms of compensation are becoming increasingly popular and making up larger and larger parts of executives' overall compensation packages.”

[<http://www.irs.gov/businesses/corporations/article/0,,id=121395,00.html>]

The 8 focal areas announced during the 11/03 Tax Talk Today are:¹⁰

- 2) Nonqualified deferred compensation
- 3) Stock-based compensation
- 4) \$1 million cap on executive compensation (§162(m))
- 5) Golden parachute compliance (§280G and §4999)
- 6) Split-dollar life insurance
- 7) Family limited partnerships and transfers of compensatory stock options (see Notice 2003-47, 2003-30 IRB 132; TD 9067 and REG-116914-03 temporary and proposed regulations under §1.83-7T)
- 8) Offshore employee leasing (see Notice 2003-22, 2003-18 IRB 851)
- 9) Fringe benefits (such as employee cars and planes, club dues)

25. Stock Option Rulings

- a. Notice 2003-47, 2003-30 IRB 132, and regulations under §1.83-7T (TD 9067 and REG-116914-03)

This notice and regulations were issued to “shut down” arrangements where executives transfer nonstatutory compensatory stock options to a related party, such as a FLP or family member, in order to defer tax on the option gains. These types of transactions and those substantially similar were also identified as “listed transactions” subject to disclosure by the executive and related party. Under the notice, “related party” does not include the service recipient or the grantor of the option (typically the employer). [Also see Treasury press release JS-521, 7/1/03.]

- b. Rev Rul 2004-60, 2004-24 IRB 1051

“Nonqualified stock options and nonqualified deferred compensation transferred by an employee to a former spouse incident to a divorce are subject to the FICA, the FUTA, and income tax withholding to the same extent as if retained by the employee.” The ruling also covers the necessary reporting requirements.

- c. Rev Rul 2004-37, 2004-11 IRB 583

A reduction in the stated principal amount of a recourse note issued by an employee to his/her employer to acquire employer stock results in compensation income equal to the amount of the debt reduction. Compensation income would also typically result from a reduction in the interest rate on the note or changing the note from recourse to non-recourse. Typically such changes are substantial modifications treated as an exchange of an unmodified note for a modified note. Resulting compensation is subject to FICA, FUTA and income tax withholding in the year the note is modified.

¹⁰ The archive of the November 2003 Tax Talk Today broadcast and resource documents can be found at <http://www.taxtalktoday.tv/>.

d. Notice 2004-28, 2004-16 IRB 783

In this notice, the IRS provides examples of some positions it became aware of that were being promoted to “take highly questionable, and in most cases meritless, positions ... on current and amended returns regarding income or alternative minimum tax (‘AMT’) due upon the exercise of nonstatutory or statutory stock options.” Taxpayers taking such positions may be subject to civil and criminal penalties, and promoters of the positions may face penalties as well. The IRS also advises taxpayers who have already filed returns relying on claims noted in Notice 2004-28 or similar positions to amend the returns “as soon as possible” and consult with a tax advisor.

The positions being promoted that the IRS was aware of include the following:

- “The options should have been taxed at their grant date rather than their exercise date.”
- “The fair market value of stock purchased under an option is reduced by any restriction placed on the stock by the employer that prohibits the employee from selling the stock for a specified period of time.”
- “When, due to a margin call, a broker sells a taxpayer’s stock that was purchased under a nonstatutory option, the stock having been pledged as security for a loan to pay the exercise price, that sale is a forfeiture of the stock that causes an ordinary loss rather than a capital loss.”
- “The purchase of the stock using borrowed funds was not in substance a purchase because the employee did not have the ability to repay the loan.”
- “Options should have been viewed as the economic equivalent of the underlying stock and thus were not subject to any taxation of the spread on exercise.”

e. LMSB Directive on §482 and Intangible Development Costs – see earlier discussion at 15 above.

26. FASB Changes

In March 2004, the FASB released an Exposure Draft on *Share-Based Payment*, calling for fair value expensing of employee stock options (rather than having a choice to expense or disclose in a footnote under FAS #123; valuation and reporting changes are also proposed). Exposure draft is available at http://www.fasb.org/draft/ed_intropg_share-based_payment.shtml.

On 10/13/04, FASB announced a 6-month delay in the effective date of the exposure draft.

27. Congressional Response to FASB Actions

Some members of Congress are opposed to the FASB proposal, while others favor it saying it will improve corporate reporting.

H.R. 3574 and S. 1890 (108th Congress) would require that the fair value of stock options granted to a company’s CEO and top 4 highest paid executives to be expensed, with an exemption for small businesses (generally \$25 million or less in revenues) and the first 3 years of new businesses. These bills also mandates and specifies what the SEC could consider “generally accepted” with respect to stock options and calls for a study by the Secretaries of Commerce and Labor on the economic effects of mandatory expensing of employee stock options on financial statements. H.R. 3574 was passed on 6/15/04 by the House Committee on Financial Services. It passed in the House on 7/20/04 by 312-111.

On June 14, 2004, the trustees of the Financial Accounting Foundation (the group that oversees and funds FASB and GASB) issued a statement in opposition to any Congressional effort to override FASB.

“We ... strongly oppose any current or proposed legislation that would undermine the independence of the FASB by preempting, overriding, or delaying the FASB’s ongoing effort to improve accounting for equity-based compensation. We believe that once Congress starts setting accounting standards through its political process, the integrity of U.S. accounting standard setting and the credibility of U.S. financial reporting will be dangerously compromised. If Congress sends the message that special interests are able, through legislation, to overturn expert accounting judgment arrived at through open and thorough due process, necessary and timely improvements in financial reporting will likely become impossible. We also strongly oppose such legislation because it will severely impede the important ongoing efforts by the FAF Trustees and the FASB to achieve international convergence of high quality accounting standards that will enable global capital markets to better serve the needs of U.S. companies and investors.”¹¹

28. Additional Stock Option Observations

- § More shareholders are voting that companies expense options on their financial statements. These companies include HP, Peoplesoft,¹² Intel,¹³ and Apple Computer.¹⁴ These votes are not binding on the companies, but instead are resolutions intended to let management know how shareholders feel.
- § In July 2003, Microsoft announced that starting in September 2003, it would only issue restricted stock to employees rather than stock options.¹⁵
- § A survey of 165 of the S&P’s 500 corporations by Deloitte found that over 75% of companies were moving away from stock options. Alternatives to options include cash bonuses, restricted stock and stock appreciation rights. The survey also found that about 2/3 of companies are running out of options already approved by shareholders.¹⁶

29. H.R. 4520 Provisions

H.R. 4520 includes various provisions changing the tax treatment of deferred compensation. For example, see new IRC §409A, Inclusion in gross income of deferred compensation and under nonqualified deferred compensation plans. Also, see §421(d) to comply with dispositions due to conflict-of-interest requirements.

VI. Acquiring, Creating or Changing Assets and Entities

30. Final Regulations on Capitalization of Intangibles (TD 9107 and related guidance)

In an effort to simplify a long-standing complex area – when should an expenditure be capitalized rather than expensed, final regulations were issued in January 2004 (TD 9107) providing guidance on deduction and capitalization of expenditures related to intangibles. In Notice 2004-6 (2004-3 IRB 308), the IRS request comments (by 3/1/04) on the application of §162 and §263 to tangible

¹¹ June 14, 2004 letter available at <http://www.fasb.org/news/nr061404.shtml>.

¹² See <http://www.issproxy.com/articles/2004archived/032.asp>.

¹³ See http://news.zdnet.com/2100-9584_22-5216301.html.

¹⁴ See http://news.com.com/Apple+vote:+Treat+options+as+expenses/2100-1047_3-998279.html.

¹⁵ See 7/8/03 press release at <http://www.microsoft.com/presspass/press/2003/Jul03/07-08CompPR.asp>.

¹⁶ See Sri Media article of 2/23/04 at http://www.srimedia.com/artman/publish/article_759.shtml.

property. In Notice 2004-18 (2004-11 IRB 605), the IRS requests comments on the treatment of costs to facilitate business acquisitions, changes in capital structure (reorganizations) and certain other transactions in order to be able to issue guidance to simplify this area. Comments were due 4/19/04.

Highlights of TD 9107:

- § The guidance is based on simplification. Thus, some subjective words are avoided, such as “enhance.” Also, in most instances, you are to look at what the regulations specifically state should be capitalized, rather than try to determine whether an expenditures produces a “significant future benefit.” The IRS is not to try to override the regulations by arguing that the clear reflection of income standard of §446(b) requires an expenditure to be capitalized.
- § Simplification was achieved by providing categories of costs that are to be capitalized. Treasury warns though that it won’t be misled by taxpayer labels, but will instead “construe broadly the categories of intangibles identified in the regulations in response to any narrow technical arguments that an intangible created by the taxpayer is not literally described in the categories.”
- § The regulations contain numerous examples which are very helpful to understanding the new rules.
- § A new rule at §1.167(a)-3(b) provides a 15-year useful life that applies to a capitalized intangible unless:
 - I. Another useful life is specifically prescribed (such as with software) or prohibited;
 - II. The intangible asset is described in §1.263(a)-4(c) (which are mostly non-amortizable entity ownership interests and §197 assets that don’t need a safe harbor) or §1.263(a)-4(d)(2) involving created financial interests;
 - III. The intangible asset has a useful life which can be estimated with reasonable accuracy (such as because it relates to a contract with a specified term); or
 - IV. The intangible is described in §1.263(a)-4(d)(8) on certain benefits arising from the provision, production, or improvement of real property in which case a 25-year life is allowed.

The safe harbor amortization method does not apply to amounts required to be capitalized under §1.263(a)-5.

Amortization under §1.167(a)-3(b) (whether the 15 or 25 year safe harbor life) is determined using the straight-line method without regard to salvage value. Amortization begins on the first day of the month the asset is placed in service with no amortization allowed in the month of disposition.

§ §1.263(a)-4: Generally, capitalization is required for:

- § Amounts paid to *acquire* an intangible (§1.263(a)-4(c)). Examples include corporate stock, a debt instrument, a future contract, a lease, a patent or copyright, a franchise, trademark or tradename, an assembled workforce, goodwill, a customer list, a servicing right, a customer-based intangible, a supplier-based intangible, software.
- § Amounts paid to *create* an intangible (§1.263(a)-4(d)) unless the 12-month rule of §1.263(a)-4(f) applies. This category includes financial interests; prepaid expenses; certain memberships and privileges (such as a fee to obtain membership in a trade association, but not to obtain a product rating or ISO 9000 certification); certain rights obtained from a governmental agency (such as a copyright or business license); certain

contract rights in excess of \$5,000 (such as a covenant not to compete); certain contract terminations (such as a lease or exclusive license agreement); certain benefits arising from the provision, production or improvement of real property; and defense of perfection of title to intangible property.

- § Amounts paid to *create or enhance a separate and distinct intangible* asset –which means “a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from a trade or business.” The following are not treated as creating a separate and distinct intangible asset: (i) amounts paid to create, originate, enter into, renew or renegotiate an agreement with the payee that produces rights or benefits for the taxpayer, (ii) amounts paid to terminate an agreement with the payee, (iii) amounts paid in performing services under an agreement even if the amounts result in the creation of an income stream under the agreement, (iv) amounts paid to develop software (unless otherwise provided in the code, regulations or other published guidance) and (v) amounts paid to develop a package design. [§1.263(a)-4(b)(3)]
- § Amounts paid to create or enhance a future benefit *identified in published guidance* in the Federal Register or IRB as an intangible for which capitalization is required.
- § Amounts paid to *facilitate* an acquisition or creation of an intangible described in one of the 4 categories above. An amount is paid to facilitate a transaction if it is paid in the “process of investigating or otherwise pursuing the transaction.” Three simplifying conventions are provided such that employee compensation, overhead, and de minimis costs (do not exceed \$5,000) are treated as not facilitating the acquisition or creation of an intangible. In determining if costs are de minimis, employee compensation and overhead are excluded from the measure. A 12-month rule may allow a taxpayer to expense costs to facilitate the creation of an intangible (§1.263(a)-4(f)).
- § Amounts paid or incurred to *facilitate an acquisition of a trade or business*, a change in the capital structure of a business entity, and certain other transactions per §1.263(a)-5.
- § §1.263(a)-5: This section provides the rules on capitalization of amounts paid or incurred to *facilitate* an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. Capitalization is required whether the transaction is a single step or series of steps comprising a single plan. An amount is paid to facilitate a transaction “if the amount is paid in the process of investigating or otherwise pursuing the transaction” based on all of the facts and circumstances. The “fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. Simplifying conventions are provided for employee compensation, overhead, and de minimis costs (do not exceed \$5,000).
- § The regulations are effective for amounts paid or incurred on or after 12/31/03. For taxpayers needing to change an accounting method to be in compliance with the regulations, Rev. Proc. 2004-23 (2004-16 IRB 785) provides guidance.
- § See Appendix A of this outline for examples of application of the new regulations.

31. Dealing with Contingent Liabilities in Determining Acquisition Costs - *Illinois Tool Works*, 2004-1 USTC ¶50,130, 93 AFTR 2d 2004-548, 355 F.3d 997 (7th Cir. 2004), affirming 117 T.C. 39 (2001)

This case involved a potential patent infringement liability that target had at the time of an acquisition. The plaintiff had tried to settle the patent infringement suit, but Target rejected the offer. Target had a \$400,000 reserve on its books for the lawsuit which was disclosed to Acquirer. Analysis by attorneys led to the conclusion that no liability would likely result from the lawsuit, and worst case it would be no more than \$3 million. For acquisition purposes, the parties considered that the potential liability was \$350,000.

Following the acquisition, a verdict was reached in the lawsuit and a verdict of about \$17 million was reached for plaintiff. A only capitalized a portion of the damages, and the IRS challenged that more of it should be capitalized. A argued that capitalization was not warranted because the payment was “highly speculative and unexpected at the time of purchase.”

Both the tax court and 7th circuit court held for the IRS, relying on contingent liability cases such as *David R. Webb Co. v. Comm’r.*, 708 F.2d 1254 (7th Cir. 1983). When the contingent liability is assumed by the acquirer of a business, it is no longer an ordinary and necessary business expense, but is instead a part of the cost of acquiring the business.

On appeal, the taxpayer argued that the damages beyond \$1 million were not due to the acquisition, but to the mishandling of the lawsuit after the acquisition. The court disagreed with this view because the taxpayer assumed the liability – whatever the amount. “That a contingent liability, once fixed, exceeded the parties’ expectations does not render it any less a part of the purchase price. ... In this case, protection from an aberrant jury verdict needed to be sought during contract formation, not after the fact in the form of an immediate tax deduction.”

32. Correcting Depreciation Problems (TD 9105 and Rev. Proc. 2004-11, 2004-3 IRB 311)

Final and temporary regulations were issued in response to conflicting court decisions as to whether a correction of depreciable life was a method of accounting (corrected via Form 3115) or a correction of an error (fixed with an amended return). The regulations provide that a change in depreciation method, recovery period or convention is a change in method of accounting. Also, a change from treating an asset as depreciable or amortizable to non-depreciable or non-amortizable or vice versa is a change in method. For changes from permissible to permissible depreciation methods, the cut-off or modified cut-off method is used. For changes from impermissible to permissible methods of depreciation, a §481(a) adjustment is computed.

The IRS also issued Rev. Proc. 2004-11 to modify the automatic change procedures of Rev. Proc. 2002-9 on depreciation/amortization method changes.

The IRS Chief Counsel Office also issued Notice CC-2004-007 in February 2004 which basically provides that for years prior to the effective date of the regulations, the IRS will not litigate situations where a taxpayer has treated a depreciation change as an error (fixed via amended return). Also see Chief Counsel Notice 2004-024 which provides additional transitional guidance.

33. Stock Losses Are Not Theft Losses - Notice 2004-27, 2004-16 IRB 782

This notice serves to advise taxpayers that any theft loss reported due to a decline in stock value caused by disclosure of accounting fraud or other illegal misconduct of corporate officers or directors, for stock purchased on the open market will be disallowed and penalties may be imposed. The IRS notes that whether a loss is a theft loss under §165 depends on whether it would be a theft under the law of the state where the alleged theft occurred. In addition, cases have held that where

stock is purchased on the open market, a decline in market value due to actions of officers and directors, is not a theft loss under §165.

34. Response to the Termination of the MIC (AB 1998, AB 2070, AB 2076, and SB 1295)

A few bills were introduced, but not acted upon, to restore the MIC. SB 1295 calls for an 8% credit, rather than a 6% one.

Governor Schwarzenegger's California Performance Review Commission issued a report in August 2004 with many recommendations "to reform and revitalize California's state government." One of the recommendations is to provide a 5% "sales tax credit for sales tax paid in the previous year on manufacturing and telecommunications equipment." The credit would be claimed on the buyer's sales tax return 12 months after the purchase and would apply to purchases through 2014. The Commission suggests that the provision would lead to over 25,000 new jobs and the reduction in sales tax revenues would be offset by increases in personal and corporate income tax receipts over the 10 years of the credit. Also, because the 5% credit represents only the state portion of the sales tax, there would be no sales tax reductions for local jurisdictions.

[<http://www.report.cpr.ca.gov/cprprt/issrec/gg/bus/gg17.htm>]

VII. Tax Administration

35. IRS Strategic Plan for 2005 – 2009

In July, the IRS released its strategic plan for 2005 – 2009 (see http://www.irs.gov/pub/irs-utl/strategic_plan_05-09.pdf). The 3 goals are:

- 1) Improve taxpayer service
- 2) Enhance enforcement of the tax law
- 3) Modernize the IRS through its people, processes and technology

36. Revised APA Procedures

Rev. Proc. 2004-40, 2004-29 IRB 50, supercedes Rev. Proc. 96-53 and Notice 98-65 to provide updated procedures for obtaining an Advance Pricing Agreement.

37. LMSB Industry Directive on Examination of Legally Mandated R&E Expenses in the Biotech and Pharmaceutical Industries

This directive should be reviewed by tax directors and tax advisors to biotech and pharmaceutical companies with R&D expenditures to which the apportionment rule of §1.861-17(a)(4) applies. The directive provides guidance to revenue agents on categories of contemporaneous documentation that may be available and useful and explains how best to use audit time and resources. The directive also calls for the agent to use the June 2003 Coordinated Issue Paper on the IRS position on the conditions under which the "legally mandated standard" is met where more than one political entity is imposing standards to be met, such as for drugs.

The directive can be found at http://www.irs.gov/pub/irs-utl/lmre_industry_directive_.pdf.

The Paper can be found at http://www.irs.gov/pub/irs-utl/legally_mandated_re_final.pdf.

38. LMSB Compliance Priorities

In December 2003, the LMSB Division of the IRS issued a statement on its compliance priorities. The Division "has a comprehensive strategy in place to balance needed enforcement with services

that support voluntary compliance” (such as various issue resolution alternatives). LMSB’s highest enforcement priority is abusive tax avoidance transactions. There will be an emphasis on promoting disclosure and “increasing tax shelter promoter investigations and investor examinations.” “Other high risk issues requiring additional research and appropriate compliance improvement action involve executive compensation, offshore tax avoidance transactions, flow-through entities, special purpose entities, and financial vs. tax reporting discrepancies.” See <http://www.irs.gov/businesses/corporations/article/0,,id=121395,00.html>.

39. IRS Assistance to Small Businesses

In May 2004, the IRS issued IR-2004-68 to let small businesses and practitioners know of the variety of resources available through the IRS website. Topics covered include starting a new business, choice of entity, how to structure a retirement plan, employment taxes information on specific industries, and help with international tax matters. There is also a link to online workshops.

See <http://www.irs.gov/businesses/small/index.html>.

40. GAO Report Comparing Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations

A 2/04 GAO report (GAO-04-358) examined the percentages of foreign-controlled corporations (FCC) and U.S.-controlled corporations (USCC) that reported no tax liabilities for 1996 – 2000. The GAO found that 71% of FCCs and 61% of USCCs reported no tax liabilities. The results were reversed though for large corporations. In 2000, the GAO estimates that 82% of large USCCs and 76% of large FCCs reported taxes of less than 5% of their total income. A large corporation is one with at least \$250 million of assets or \$50 million of gross receipts. Such corporations represent 1% of all corporations, but 93% of total corporate assets.

See <http://www.gao.gov/new.items/d04358.pdf>.

41. Draft Schedule M-3

One of the responses of the IRS to aid it in better identifying possible tax shelters is to increase corporate reporting of book-tax differences in more detail than the current M-1 provides. The M-3 was released in January 2004 and comments were requested. Draft instructions were released in March and the final instructions are expected by September 2004. In July 2004, Treasury and IRS released a “draft of the final version” of the form. All domestic corporations and U.S. consolidated groups with total assets of \$10 million or more are to file the M-3 rather than Schedule M-1 (thus, corporations in the audit reach of the LMSB Division).

The “final version” is marked as a “draft” so that the form could be released early to allow for practitioners and programmers to get ready to implement the new form. Schedule M-3 will be due for tax years ending on or after 12/31/04. For the first year, corporations are not required to complete columns A and D of Parts II and III of the form.

A detailed Q&A was also released by Treasury -
http://www.ustreas.gov/press/releases/reports/js1770_m3_faq070704.pdf

The Schedule M-3 can be found at
http://www.ustreas.gov/press/releases/reports/js1770_1_m3070704.pdf

The draft M-3 instructions can be found at
http://www.ustreas.gov/press/releases/reports/js1770_m3_instructions3112004.pdf

In addition, Rev. Proc. 2004-45 was released which provides alternative disclosure procedures to eliminate the overlap between the M-3 and the return disclosure regulations finalized in February 2003 (§1.6011-4 addressing six categories of reportable transactions). See http://www.treas.gov/press/releases/reports/js1768_1_rp_2004_45_070704.pdf.

Observations: (1) Many corporations and their tax advisors are not aware of the new form, yet it is due for 2004. (2) M-3 applies a transaction approach for identifying book-tax differences, while M-1 was more of a balance sheet approach. (3) One of the listed transactions to be reported under Reg. §1.6011-4 is any book-tax difference in excess of \$10 million. However, this only applies to reporting companies under SEC rules and business entities with \$250 million or more of gross assets for book purposes. The Schedule M-3, in effect, expands the intent of this reporting requirement. (4) Schedule M-3 will also become part of forms 1065 and 1120S soon.

42. Priority Guidance Results and Plans

On 9/13/04, in a Treasury Department press release, Eric Solomon, Deputy Assistant Secretary, Treasury and Nicholas J. DeNovio, Deputy Chief Counsel, IRS, stated:

“We kept up the pace of published guidance in 2003-2004 with another strong year. For the 12-month business plan year that just ended June 30, 2004, we published 314 total projects. We issued 77 revenue rulings. We published 66 final and temporary regulations and 38 proposed regulations. The expedited guidance program resulted in 31 items of published guidance. We also devoted significant resources to some high profile projects that we expect to publish soon, such as regulations on cost sharing, dual consolidated losses and cross-border mergers.”¹⁷

Items on the 004-2005 Priority Guidance Plan, issued on 7/26/04, relevant to high tech companies includes:¹⁸

- § Regulations under §41 on computation of the research credit for controlled groups.
- § Regulations under §41 regarding gross receipts for purposes of computing the group credit under §41(f).
- § Guidance on incentive stock options

43. CA Tax Shelter Crackdown

California FTB’s Voluntary Compliance Initiative resulted in the collection of over \$100 million from taxpayers who used “illegal tax shelters.” The Initiative ended April 15, 2004 and now brings in harsher penalties authorized under SB 614. The FTB estimates that losses from abusive tax shelters totals \$600 million to \$1 billion annually. [FTB Press Release “Illegal Tax Shelter Crackdown Hits \$100 Million.”]

VIII. Non-Tax Developments of Relevance

44. Sarbanes-Oxley to E-Waste

There are always developments and activities in non-tax areas with potential tax implications. A few of these current items include:

- § Continued interpretation of Sarbanes-Oxley – this may have relevance to high tech companies (and others) on how they obtain tax services.
- § GAAP and SEC (& Congress) activities – will Congress act to prevent FASB from defining GAAP with respect to the reporting of stock options? If yes, what’s next?

¹⁷ Press release of 9/13/04, js-1913; available at <http://www.ustreas.gov/press/releases/js1913.htm>.

¹⁸ The full text of the plan can be found at <http://www.ustreas.gov/press/releases/reports/guidanceplan20042005.pdf>.

- § Efforts to promote broadband – a variety of efforts have been made by governments and others to expedite the spread of the use of broadband. Often tax incentives are a tool for promoting usage. Wider use of broadband would also affect how companies market intangibles and services which would increase the concerns of state and local governments over potential loss of revenues from an increasing field of non-present vendors.
- § Concerns about too much outsourcing – legislative constraints may change how companies develop, produce and market products. Tax benefits may be designed to encourage companies not to outsource.
- § Increased globalization – when more and more businesses of all sizes and ages operate and sell in the global market, tax rules and administration will need some updates.
- § Continuing concerns over privacy and security – tax agencies are concerned about paper trails, taxpayers are concerned over security of their personal data.
- § Cyberspace jurisdiction – rulings in the non-tax area as to what actions may cause a state to have jurisdiction over a party may have tax implications as well.
- § Software piracy - The Business Software Alliance reports that 36% of software in use worldwide is pirated – a revenue loss of about \$29 billion worldwide. The piracy rate for the U.S. was 22% - about a \$6 billion annual loss. An April 2003 study found that lowering piracy by 10 percentage points over 4 years would result in an increase of 1 million jobs and \$400 billion in economic growth worldwide.¹⁹ Piracy also means a significant loss of income, sales and value-added tax revenues.
- § E-Waste – concern over hardware garbage may lead to excise taxes on hardware and/or tax incentives for recycling activities. As reported in “Recycling ‘E-Waste,’” by Cris Prystay in the 9/23/04 *Wall Street Journal* (p. B1):
 - In 2001 in U.S., only 1 of 9 retired computers was recycled.
 - In 2003, the EU passed a directive requiring its member countries to have manufacturers take back up to 75% of products sold in the EU, effective in 2005.

Per “Old Cellphones Pile Up by the Millions” by Jesse Drucker in the 9/23/04 *Wall Street Journal* (p. B1):

- Yankee Group, Inc. reports that about 100 million cellphones will be retired in the U.S. in 2004. They estimate that about 2/3 will be stored by the owner with only about 5 million refurbished or recycled. That leaves about 25 million cellphones ending up in the trash.
- The EPA reports that the amount of lead in cellphones makes them hazardous waste.

In 2003, California enacted the Electronic Waste Recycling Act [SB 20 (Sher), Chapter 526, Statutes of 2003] This Act requires the collection of a recycling fee on certain electronic products. For more information, see <http://www.ciwmb.ca.gov/Electronics/Act2003/> and <http://www.dtsc.ca.gov/HazardousWaste/CRTs/SB20.html>.

¹⁹ See full report at <http://www.bsa.org/globalstudy/>.

Appendix A²⁰Examples of Application of the Final Regulations (TD 9107) on Intangibles²¹

Expense	Capitalize
\$800,000 incurred to create an invention and obtain a patent (deductible under §174).	\$800,000 to purchase Company X's patent.
\$400,000 incurred in-house to develop a software program for tracking customer orders (unless the taxpayer elects under Rev. Proc. 2000-50 to capitalize this amount).	\$400,000 to purchase 100 copies of software for tracking customer orders.
\$100,000 paid to employees and for materials to create a package design for payor's product. ²²	Acquisition of a §197 intangible, such as: § \$100,000 to acquire package designs from another business; § \$300,000 paid to Company X to acquire its list of customers.
No contrasting example – acquisition of an ownership interest in an entity has to be capitalized.	Acquisition of an ownership interest in an entity, such as: § \$5,000,000 to acquire a call option from Y Corporation which entitles the holder to purchase W Corporation stock from Y. § \$2,000 paid to acquire an interest in XYZ Partnership.
\$200,000 to run a TV commercial promoting the company and its products. ²³	No contrasting example – advertising expenditures are likely to always be currently deductible.
\$2,000,000 paid to customer X as promised if X purchased \$20,000,000 of goods from payor over a 3-year period as no intangible was created. ²⁴	\$2,000,000 paid to customer X to induce them to enter into a 5-year “take or pay” purchase contract. Under the contract, X is required to pay for a specified minimum amount of product, whether or not X takes delivery of the product. ²⁵
\$300,000 paid on December 1 for a 1-year casualty insurance policy that begins on December 15.	\$300,000 paid on December 1 for a 1-year casualty insurance policy that begins on January 15 of the following year.
	\$300,000 paid for a 3-year casualty insurance policy.

²⁰ This table is from an article published in *Business Entities* – “Tangible Guidance on Intangibility – New Section 263 Regulations Provide Taxpayers with Certainty,” by Tom Purcell and Annette Nellen, Sept/Oct 2004.

²¹ Most of these examples are based on the numerous examples contained in the regulations.

²² Reg. § 1.263(a)-4(l) Example 9.

²³ This is the result under Rev. Rul. 92-80, 1992-2 CB 57, and would continue under the new regulations because advertising is not one of the created intangibles specified at Treas. Reg. §1.263(a)-4(d) and is not a separate and distinct asset under Reg. §1.263(a)-4(b)(3) because nothing is created that can be transferred. Also see Reg. §1.263(a)-4(l) Example 7 on the treatment of product launch costs.

²⁴ Reg. § 1.263(a)-4(d)(2)(vi) Example 6.

²⁵ Reg. § 1.263(a)-4(d)(2)(vi) Example 4.

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Expense	Capitalize
\$60,000 paid by a cash method lessee at year end to use property for the first six months of the subsequent year.	If the taxpayer were instead an accrual method taxpayer, the economic performance (EP) rules of §461(h) would apply and EP would not be met until the taxpayer used the property in the subsequent year. Thus, the payment would not be “incurred” until the next year when it would be expensed. A capitalization versus expensing determination is not necessary until an expenditure has been incurred under the §461 rules. ²⁶
\$10,000 paid to Advertisers, Inc. to terminate a contract with AI. ²⁷	X and Y have an agreement that X may be the exclusive manufacturer and distributor of goods using Y’s design and trademarks for 10 years. Two years into the agreement, Y pays X \$5,000,000 to terminate the agreement. ²⁸
\$40,000 paid to terminate a lease which allows for such an early termination fee.	
\$5,000 paid to Advertisers, Inc. to enter into a contract requiring them to be available to provide services to the payor for 2 years (amount is de minimis). ²⁹	\$10,000 paid to Advertisers, Inc. to enter into a contract requiring them to be available to provide services to the payor for 2 years (amount exceeds \$5,000 so is not de minimis).
\$22,000 incurred by Advertiser’s Inc. (see above) for training and a party for customer P’s employees in the hopes that P will renew the advertising contract. ³⁰	\$22,000 paid to enter into a 10-year lease of real property with owner X. ³¹
\$100,000 paid to Consumers Quality to obtain a safety rating on payor’s product. ³²	\$100,000 to obtain a lifetime seat on a stock exchange.
\$2,000,000 incurred to obtain ISO 9000 certification on payor’s business processes.	\$2,000,000 to obtain lifetime staff privileges at a hospital.
\$25,000 signing bonus paid to new employee E where E is not required to return the bonus upon leaving and is not legally required to work for any set period of time. ³³	\$25,000 paid to X to terminate a lease so that a more favorable lease can be entered into between the parties. ³⁴
Commissions paid by a telecom company to third party distributors for acquiring new customers for cellular service. ³⁵	\$5,000,000 paid to X whereby X agrees not to acquire any more stock in payor for 10 years. ³⁶

²⁶ Reg. § 1.263(a)-4(f)(6) and (f)(8) Examples 10 and 11.

²⁷ Reg. § 1.263(a)-4(d)(7) and Example 1 at (d)(7)(iii).

²⁸ Reg. § 1.263(a)-4(b)(3)(ii).

²⁹ Reg. § 1.263(a)-4(d)(6).

³⁰ Payments for the mere hope or expectation of maintaining a relationship, that is not contingent on the renegotiation, are not required to be capitalized. Reg. § 1.263(a)-4(d)(6)(ii).

³¹ Reg. § 1.263(a)-4(d)(6) and Example 1 at (d)(6)(vii).

³² Reg. § 1.263(a)-4(d)(4).

³³ Reg. § 1.263(a)-4(d)(6)(vii) Example 8.

³⁴ Reg. § 1.263(a)-4(d)(i)(A) and Example 3 at (d)(6)(vii).

³⁵ Note that this result is contrary to an earlier IRS position in TAM 9813001 which held that such costs had to be capitalized. This appears, however, to be the correct result per Reg. § 1.263(a)-4(b)(3) and -4(d) because it is an

Expense	Capitalize
The cost of a computer given to a customer at no charge to induce the customer to enter into a multi-year telecommunications contract with the provider. The fair market value of the computer is equal to or less than \$5,000. ³⁷	The cost of a computer given to a customer at no charge to induce the customer to enter into a multi-year telecommunications contract with the provider. The fair market value of the computer exceeds \$5,000.
Approximately \$400,000 incurred by Bank to perform credit checks, cover employee wages in the loan origination department and related overhead costs to generate 120 home equity loans during the year. ³⁸	The principal amount of the loans made by Bank X to its home equity loan borrowers. ³⁹
No contrasting example – most expenditures associated with real property acquisition or development must be capitalized.	\$1,000,000 paid to the city to help cover the costs of a new public bridge that will greatly benefit the payor's business operations. ⁴⁰
\$500,000 of litigation costs to defend against a patent infringement suit where title is not at issue. ⁴¹	\$500,000 paid to X who has brought a patent infringement suit against payor. The payment releases X's claims to the patent. ⁴²
\$4,000 paid to attorney A and \$1,000 paid to attorney B to help payor negotiate a 25-year commercial lease. ⁴³	\$4,000 paid to attorney A and \$2,000 paid to attorney B to help payor negotiate a 25-year commercial lease (the total amount is not de minimis). ⁴⁴
\$2,000 of employee compensation and \$4,000 of outside	\$25,000 paid to the state to obtain a liquor license that

amount paid to create a contract right. Because the amount is not paid to provide services to the payee, it does not fall under a created contract right described at Reg. § 1.263(a)-4(d)(6). In addition, this transaction should not be viewed as the acquisition of a customer list under § 197 as the payment represents commissions paid for single contracts.

³⁶ Reg. § 1.623(a)-4(d)(6)(i)(D) and Example 7 at (d)(6)(vii).

³⁷ Reg. § 1.263(a)-4(d)(6)(vii) Example 10.

³⁸ This result is in line with the 3rd Circuit decision in *PNC Bancorp Inc. et al. v. Comm'r.*, 85 AFTR2d 2000-1854 (3d Cir. 2000), where the court held that a bank did not have to capitalize certain costs of obtaining/issuing loans. The lower court had held to the contrary - that a bank had to capitalize the costs of originating loans (110 T.C. 349 (1998)). The final regulations with the simplifying conventions for employee wages and overhead also, in effect, overrule *Lychuk v. Comm'r.*, 116 T.C. 374 (2001), where the court held that direct costs, such as employee wages related to acquiring installment loans had to be capitalized. See Reg. § 1.263(a)-4(e)(4) and Example 8 at (e)(5).

³⁹ Reg. § 1.263(a)-4(d)(2)(vi) Example 1. The principal amount of a loan is an amount paid to another party to create a debt instrument and must be capitalized per Reg. § 1.263(a)-4(d)(2)(i)(B).

⁴⁰ Reg. § 1.623(a)-4(d)(8) and Example 1 at (d)(8)(v).

⁴¹ See *Urquhart v. Comm'r.*, 215 F.2d 17, 45 AFTR 1861, 54-2 USTC ¶9566 (CA-3, 1954) where the court held that the legal action was more about protecting business profits than title to a patent. Also see Reg. § 1.263(a)-4(e)(5) Example 6, *Rust-oleum v. Comm'r.*, 21 AFTR 2d 516, 280 F Supp 796, 68-1 USTC P 9168 (ND Ill 1968) and FSA 199925012 (6/25/99).

⁴² Reg. § 1.263(a)-4(d)(9).

⁴³ Reg. § 1.263(a)-4(e)(4).

⁴⁴ Reg. § 1.263(a)-4(e)(5) Example 1. Per Reg. § 1.263(a)-4(e)(4)(iii)(A) a taxpayer must aggregate transaction costs to determine if they are de minimis.

legal expenses incurred to obtain a liquor license. ⁴⁵	is valid indefinitely. ⁴⁶
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⁴⁵ The employee compensation is a facilitative cost that falls under a simplifying convention and so does not have to be capitalized. The \$4,000 of legal expenses is de minimis and so also does not have to be capitalized. A taxpayer could instead elect to capitalize these amounts per §1.263(a)-4(e)(4)(iv). An election is made per transaction and applies to employee compensation, overhead, or de minimis costs, or any combination thereof. Reg. §1.263(a)-4(l) Example 1.

⁴⁶ The cost of the liquor license is an acquired intangible that must be capitalized per Reg. §1.263(a)-4(d)(5)(i). Reg. §1.263(a)-4(l) Example 1.

Expense	Capitalize
\$800,000 of costs for salaries and outside consultants to create and implement a just-in-time manufacturing process that provides savings to the payor over the long term. ⁴⁷	\$800,000 paid to obtain the right to operate a manufacturing franchise to allow it to use the payee's processes and trademarks. ⁴⁸
\$50,000 bonus paid to the CEO for negotiating the acquisition of target corporation. ⁴⁹	\$50,000 paid to a law firm to assist in getting the payor's stock registered with the SEC. ⁵⁰
<p>Treas. Reg. § 1.263(a)-5:</p> <p>§ \$300,000 incurred to relocate employees, integrate financial records, and provide severance benefits due to a merger.⁵¹</p> <p>§ \$700,000 paid to employees of target for cancellation of their stock options due to a merger.⁵²</p>	<p>Treas. Reg. § 1.263(a)-5:</p> <p>§ \$250,000 paid to an investment banker to evaluate the possibility of an initial public offering.⁵³</p> <p>§ \$5,000,000 of legal and investment banking fees to pursue an IPO.⁵⁴</p> <p>§ \$90,000 incurred for due diligence to consider the acquisition of Target Corporation (T). On 3/1/05, payor entered into an agreement to acquire T and continued to incur costs for due diligence, to draft the merger agreement, obtain shareholder approval and prepare SEC filings. Costs incurred on or after 3/1/05 are required to be capitalized. Due diligence costs prior to that date are expensed. Inherently facilitative amounts, such as costs to determine the value of T, prepare SEC filings and draft the merger agreement must be capitalized regardless of when incurred.⁵⁵</p>
\$80,000 in legal fees incurred to seek an injunction to fight a hostile takeover. ⁵⁶	\$50,000 in legal fees to defend against antitrust litigation stemming from the acquisition of a competitor. ⁵⁷

⁴⁷ Reg. § 1.263(a)-4(l) Example 5. This conclusion is contrary to that reached in TAM 9544001 (7/21/95). In the TAM the taxpayer was also required to capitalize the costs of creating training manuals. Under the new regulations, that holding should remain unchanged if the manuals are considered a separate and distinct intangible created by the taxpayer that is subject to protection under federal law (copyright law) and intrinsically capable of being sold, transferred or pledged (§1.263(a)-4(b)(3)).

⁴⁸ Reg. § 1.263(a)-4(l) Example 2.

⁴⁹ Reg. § 1.263(a)-5(l) Example 5.

⁵⁰ Reg. § 1.263(a)-5(l) Example 1.

⁵¹ Reg. § 1.263(a)-5(l) Example 6.

⁵² Reg. § 1.263(a)-5(l) Example 7.

⁵³ Reg. § 1.263(a)-5(l) Example 3. If the IPO plan is later abandoned, the \$250,000 may be written off under §165.

⁵⁴ Reg. § 1.263(a)-5(l) Example 15.

⁵⁵ Reg. § 1.263(a)-5(l) Example 4.

⁵⁶ Reg. § 1.263(a)-5(l) Example 11.

⁵⁷ Reg. § 1.263(a)-5(l) Example 10.