Office of Chief Counsel
Internal Revenue Service
memorandum

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date: April 27, 2011

to: Team Coordinator
(Large Business & International)

from: Associate Area Counsel
(Large Business & International)

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subject: Taxation of ######## Commercialization Agreements

This memorandum responds to your request for assistance relative to the tax treatment of the Device A transaction reported by Corporation A on its Year 1 tax return. This advice may not be used or cited as precedent.

LEGEND

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Corporation B =
Corporation C =
Corporation D =
Corporation E =
Corporation F =
Corporation G =
Corporation H =
Agreement A =

Agreement B =

Agreement C =

Agreement D =
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Agreement H =

Agreement I =
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Territory B =
Patent A =

Patent B =
Patent C =
Patent D =
Patent E =
Patent App. F =
Patent App. =

G

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Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
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Payment(s) A	=
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Amount 45	=
Amount 46	=
Amount 47	=
Amount 48	=
Government Agency A	=
Industry A	=
Industry B	=
Industry C	=
Device A	=
Device B	=
Device C	=
Product(s)	=

Territory A =
Trademarks
Country B =
Trademark A
Country B =
Trademark B
Use A =
Use B =
Use C =
Study =

All numbers, months, days or single use words without a specific legend abbreviation are replaced with ##.

ISSUES

1. Whether Corporation A is estopped from retroactively asserting the Agreement A was a sale agreement after representing it was a license in a closing agreement that Corporation A executed in Year 3.

2. Whether, by accelerating the income due under the Agreement A in the Agreement B thereto, Corporation A can change the character from ordinary to capital.

3. Whether, pursuant to the terms of the Agreement B, Corporation A sold Device A, Corporation B's patents and Corporation B's know-how.

4. Whether, pursuant to the terms of the Agreement B, Corporation A can be treated as selling its own patents and know-how, or the Agreement C.

5. Whether the Agreement B constitutes a franchise.

6. Alternatively, if the Agreement B did effect a sale of property, whether Corporation A properly applied the installment reporting method as required by I.R.C. §§ 453, 453A and 483, and whether installment sale reporting applies to the Agreement B if it is a franchise.

CONCLUSIONS

1. Corporation A is estopped from retroactively asserting the Agreement A is a sale agreement after representing it was a license in a closing agreement that Corporation A executed in Year 3.

2. Corporation A cannot change the character of income due under the Agreement A by accelerating the receipt of the income.

3. Corporation A did not own Device A, Corporation B's patents or Corporation B's know-how that Corporation A asserted it sold. Accordingly, Corporation A could not have sold the property.

4. The Agreement B cannot be treated as selling any patents, know-how or the Agreement C.

5. The Agreement B constitutes a franchise, and ordinary income was realized from the transfer of the franchise because Corporation A retained significant power, rights or other interests in the transferred franchise.

6. Alternatively, if Corporation A could be treated as selling any property in Year 1 which qualified for reporting under the installment method, Corporation A failed to correctly apply the installment method. Corporation A must apply the installment method in a manner consistent with the statute and regulations. The sale or disposition of a franchise on installment terms, generally, would be subject to the installment method provided that Corporation A's evidence of indebtedness was not payable on demand or readily tradable and Corporation A did not elect out of the installment method. Corporation A did not elect out of the installment method.

FACTS

Agreement C Agreement between Corporation B and Corporation A

Development of Device A: Year 14 - Year 15

Agreement A with Corporation G

Agreement L Between Corporation A and Corporation B

Development of Device A: Year 11 – Date

<u>Agreement B Agreement Between Corporation A and Corporation G</u>

Subsequent Activities Following the Agreement B

Year 13 Agreements Between Corporation A and Corporation B

Corporation A's Position

At all times, for book and tax purposes, Corporation A treated the Agreement C as a license. Corporation A does not contend that the Agreement C constituted a sale agreement, either as originally executed or as modified.

In Years 12 and 3, for book and tax purposes, Corporation A treated the Agreement A as a license, not a sale agreement. Additionally, as to the Year 3 tax year, Corporation A entered into a Form 906, Closing Agreement on Final Determination Covering Specific Matters, which represented that the Agreement A was a license for tax purposes. On Date 49, Corporation A received the $Amount 15 Payment A from Corporation G due under the Agreement A. Corporation A agreed in the closing agreement that the $Amount 15 Payment A "it received was for use of intellectual property and was an advance payment as defined in Rev. Proc. 2004-34," and acknowledged that Rev. Proc. 2004-34, 2004-1 C.B. 991 applied "to advance payments received for the use, including by license, of intellectual property." In other words, Corporation A agreed that the $Amount 15 was paid under a license to use intellectual property and sought (and was granted) a one-year deferral for recognition of the income pursuant to Rev. Proc. 2004-34. Accordingly, Corporation A is estopped from repudiating the representations made in support of the binding closing agreement for Year 3

On its Year 1 tax return, Corporation A reported that it sold either the Device A or the Device A License,[1] using the installment method (reporting some of the deferred income on its Year 13 tax return).

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[1] On line one of its Year 1 Form 6252, Installment Sale Income, Corporation A

As we understand Corporation A's basic position for this case, Corporation A contends that it sold to Corporation G "all" of its rights under the Agreement C with Corporation B in either Year 12 or Year 1,[2] with the $Amount 34 lump sum payment and the estimated net present value of the Amount 2 years of royalties constituting the amount realized for the sale. Corporation A did not include in its amount realized the estimated net present value of any of the other payments due or obligations assumed under the Agreement B.

To date, Corporation A has not identified exactly what it specifically contends was sold to Corporation G. Further, Corporation A asserts that the unamortized balance of the Payment B and Payments A that Corporation A paid Corporation B pursuant to the Agreement C constitutes its basis in the property sold. Corporation A further contends the resulting net gain is capital, reportable over time using the installment method, pursuant to I.R.C. § 453.

It is our understanding that the continuing income Corporation A receives from selling the Device A to Corporation G is reported by Corporation A as separate income. It is our further understanding that Corporation A contends that all other payments received or to be received from Corporation G pursuant to the terms of the Agreement B, including reimbursements, which Corporation A owes to others, can be netted out so not includable in income. It is not clear how Corporation A intends to report the continuing Amount 36 percent royalty (not scheduled to start until Date 50); however, it is our understanding from oral representations to the Service that Corporation A contends the income should be treated as fees for services (acting as) and excluded from the consideration for the "sale". Such representations are inconsistent with the plain and unambiguous language of the Agreement B identifying the amounts as royalties.

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[2] The 'sale' was initially reported on Corporation A's Year 1 tax return, but during discussions with the Service, Corporation A indicated that the sale to Corporation G *might* actually have occurred in Year 12 under the initial agreement, instead of under the Agreement B.

Corporation G did in Date 51,
Country B Trademark A for Use B. In Date 52 .
Corporation G has not become the registered owner in the Government Agency A on-line data base of any of Corporation A's or Corporation B's patents the subject of the Agreement A or the Agreement B.

Corporation A has a "Whitepaper" prepared by that addresses its reporting of the Device A transaction; however, despite repeated oral and written requests from the Service, Corporation A has not provided the "Whitepaper."

LAW AND ANALYSIS

For the Agreement A: Corporation A is estopped from repudiating the representations made in the Form 906, Closing Agreement on Final Determination Covering Specific Matters for the Year 3 tax year. The closing agreement clearly and unambiguously represented that the Agreement A was a license and provided for the tax treatment of the various payments pursuant to the license, as stated with more specificity in the fact section above. It is well settled law that, once executed, a closing agreement is final and conclusive and thus irrevocable except for fraud, malfeasance or a misrepresentation of a material fact. I.R.C. § 7121(b); Treas. Reg. § 301.7121-1(c); Marathon Oil Co. v. United States, 42 Fed. Cl. 267 aff'd 215 F.3d 1343 (Fed Cir. 1999). A closing agreement is, in effect, a mutual release which binds both parties, and cannot be set aside except on the grounds stated in § 7121. Section 7121(b)(1) specifically states that a closing agreement "shall not be reopened as to the matters agreed upon." This means that the facts recited therein may not be disputed. Post-closing agreement transactions do not alter this result. Corporation A must report the $Amount 15 payment in Year 1 as agreed to in the closing agreement. All subsequent payments relating to the license must be reported consistent with the license treatment stipulated to in the closing agreement.

Accordingly, since there was no fraud, malfeasance or misrepresentation of material fact, Corporation A is estopped from asserting the Agreement A can be treated as selling any rights. Alternatively, if not estopped, the Agreement A cannot be treated as a sale agreement for all the reasons the Agreement B cannot be treated as a sale agreement; both are mere licenses or, at most, a transfer of a right to develop and commercialize Country B Trademark A in the Territory B that constitutes a franchise with all income ordinary, as addressed below. Moreover, if anything was sold or a franchise was transferred, Corporation A failed to properly apply the installment sale rules, as addressed below with respect to the Agreement B.

For the Agreement B: The Agreement B did not effectuate a sale of any rights or property; rather, the Agreement B merely accelerated the payments already due pursuant to the terms of the Agreement A (a license per the closing agreement), as addressed in **Section A**.

Alternatively, if the Agreement B is not a mere acceleration of payments already due pursuant to the Agreement A, the Agreement B cannot be treated as selling the Device A, any of the patents, any know-how that rises to the level of property, or the Agreement C, as addressed in **Section B**.

Alternatively, if the Agreement B did transfer any property, what was transferred constitutes a franchise with the character of the income received ordinary, as addressed in **Section C**.

Alternatively, even if some right that rises to the level of property was sold or a franchise transferred, Corporation A failed to properly apply I.R.C. Sec. 453 (installment method) and I.R.C.§§ 453A and 483, and should apply these sections as addressed in **Section D**.

Section A
Acceleration of Receipt of Income
Does Not Change Income Character

The income Corporation A received from Corporation G was ordinary income because it was received as a substitute for the ordinary income that Corporation A was to receive under the Agreement A with Corporation G. The underlying transaction is an acceleration of the stream of royalty income expected in the future from the licenses and sublicenses in the Agreement A; not a sale of property that gives rise to capital gain (Sections B and C).

The character of gain is fixed by reference to the underlying transaction. See Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (transferee obligation incurred as a result of judgment entered against corporation following its liquidating distribution to shareholders was a capital loss to the shareholders because the liquidating distribution was capital); Hort v. Commissioner, 313 U.S. 28, 32 (1941)(amount lessor received in consideration of a cancellation of a real estate lease was taxed as ordinary income for it "involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises"); Smith v. Commissioner, 48 T.C. 872, 880 (1967), aff'd in part and rev'd in part on another issue, 424 F.2d 219 (9th Cir. 1970) (purchaser of timberland in a prior year elected to prepay remaining purchase price at a discount, loss to seller due to the discount was capital since the original transaction was capital).

The Agreement B simply modified the royalty payments to be made under an existing licensing and sublicensing agreement Corporation A had with Corporation G. The royalty payments were accelerated, with Corporation A receiving $Amount 34 up-front, with reduced royalty rates going forward. Indeed, Corporation A concedes that the rights of the parties were not materially altered by the amendment, which is the reason Corporation A asserts that Corporation B's agreement to the amendment was unnecessary. Corporation A's , stated Corporation A wanted its expected royalty income upfront because it was concerned that

could jeopardize, reduce, or eliminate the stream of royalty income in the future.

The mere acceleration of receipt of income under a contract does not change the character of the income received. Hallcraft Homes, Inc. v. Commissioner, 336 F.2d 701, 705 (9th Cir. 1964) (lump sum payment made by City of Phoenix, which acquired liabilities of water companies to pay a developer a percentage of water company receipts for almost 20 years, was ordinary income to developer since the payments over time which the lump sum was paid in lieu of generated ordinary income).

Substituting a current payment for amounts to be paid in the future does not change the character of the income from ordinary to capital. The substitute for ordinary income doctrine was established in Hort v. Commissioner, 313 U.S. 28 (1941). In Hort, a bank entered into a lease with a taxpayer, but found that it was unprofitable to maintain a branch bank in the building. As a result of negotiations, the bank and the taxpayer agreed to cancel the lease upon the bank's payment of $140,000. Hort did not report the $140,000 as income, but claimed a loss of ($21,494.75) on the theory that he did not receive all of the monies that he would have received if the lease would not have been canceled, with the ($21,494.75) reflecting the difference between the present value of what he would have received had the lease remained in place and the $140,000 that he received to cancel the lease. The Court rejected the taxpayer's position, finding that the entire $140,000 received had to be included in the taxpayer's income, that it was not a return of capital even though the contract that created the right to receive the income may be treated as "property" or "capital", and that it had to be treated as ordinary income since the "cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises." Hort, 313 U.S. at 32.

In Commissioner v. P.G. Lake, 356 U.S. 260 (1958), the Supreme Court decided that the mere conversion of a right to future income into present income in four cases involving the transfer of oil payment rights,[3] and in one case involving the transfer of a sulphur payment right, did not convert the income received from ordinary income into capital gains income. While recognizing that, under state law, oil payments were interests in land, the transfer of said oil payments still generated ordinary income because the

> lump sum consideration [received by the transferors] seems essentially [like] a substitute for what would otherwise be received at a future time as ordinary income. …The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

P.G. Lake, 356 U.S. at 265-266.[4]

In Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (10th Cir. 1962), Stanolind Oil and Gas Co. and Halliburton entered into an agreement whereby Stanolind granted to Halliburton the "right to develop and use commercially" under the trade name 'Hydrafrac Process,' an unproven method, known as hydraulic fracturing, which it had invented for the creation and stimulation of production from oil and gas wells." Except for use by Stanolind and its affiliates, the agreement granted to Halliburton a non-transferrable right to use the process and, subject to Stanolind's approval, to issue sub-licenses to others to use the process. Royalties of $100 per use were to be paid to Stanolind, with the license to Halliburton to become exclusive if the royalties due and payable to Stanolind reached $300,000 by a date certain. At some point, the license to Halliburton became exclusive.

The process was in the experimental stage and had not been commercially developed when Halliburton and Stanolind initially entered into their agreement in 1949. The

[3] An oil payment is "'the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced.'" P.G. Lake, 356 U.S. at 262, n.1, quoting Anderson v. Helvering, 310 U.S. 404 (1940)

[4] Hort and P.G. Lake are viewed as cases in which the right to receive future income was "carved out" of property rights held by the taxpayer, with the taxpayer retaining an interest in the underlying property. However, the substitute-for-ordinary-income doctrine also has been applied to deny capital gain treatment for transactions involving interests that do not represent "carve-out" transactions. For instance, capital gain treatment is denied for interests related to compensation for past or future services. See, e.g., Freese v. United States, 455 F.2d 1146 (10th Cir. 1972) (lump sum representing unpaid commissions due under an employment contract); Elliott v. United States, 431 F.2d 1149 (10th Cir. 1970) (lump sum paid for the surrender of right to future sales commissions); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (payment for interest in films to be produced by taxpayer). Similarly, courts have denied capital gain treatment for interests relating to income already earned or about to be earned. See, e.g., United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (earned original issue discount); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

process still needed to be tested in the field. Per the agreement, both Stanolind and Halliburton were to continue to develop and improve the process, and each party agreed to share all technical information. Additionally, Halliburton was to promote the process to others in the industry. The agreement was to stay in place until the expiration of any patents Stanolind received related to the process. Stanolind did obtain patents in connection with the process, which patents remained the property of Stanolind.

Pursuant to the 1949 agreement, Halliburton generated a great deal of know-how and technical ability in respect to the licensed process by performing laboratory work, training personnel, and developing special mechanical equipment, with some of Halliburton's work culminating in the receipt of its own patents. Halliburton's information, and patents, could be shared with Stanolind under their agreement.

In a relatively short period of time, demand for use of the process became so great that Halliburton could not manufacture equipment nor train personnel quickly enough to supply the demand. While Halliburton had the ability to issue sublicenses to help meet the increasing demand, Halliburton did not want to be in the position of sub-licensing to its competitors. In 1952, at Stanolind's request, the parties entered into negotiations to address the problem of meeting the growing demand.

In 1953, the parties reached an agreement whereby Halliburton terminated its right to an exclusive license and accepted a non-exclusive license, plus a sum equal to one-third of the royalties which Stanolind received from third-party licensees. Additionally, Stanolind was given an irrevocable right to supply other licensees with the technical data that had previously only been available to Stanolind from Halliburton. As a result, Stanolind was able to license the process to Halliburton's competitors.

Halliburton reported the license royalties as capital gain income. The Tenth Circuit Court of Appeals, however, held that the royalties were to be treated as ordinary income since Halliburton obtained the right to a portion of the royalties earned by Stanolind by giving up its right under the initial contract with Stanolind to grant third party licenses directly. The court found that Halliburton was paid one-third of the royalties received by Stanolind not due to any increase in the value of the licensed property, but in consideration for the future income Halliburton could have earned if it had been willing to issue sublicenses to competitors directly.[5] Significantly, even though Stanolind also acquired an irrevocable right to share technical know-how with new licensees, including the technical data developed by Halliburton, all of the income received by Halliburton under the modified agreement was ordinary income.

[5] The Second Circuit noted that the basis for the denial of capital gain treatment in Halliburton was the "equivalence between amounts paid for its surrender and income that would have been realized by its retention." Commissioner v. Ferrer, 304 F.2d 125, 133 (2nd Cir. 1962).

Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006), cert. denied, 549 U.S. 1212 (2007), provides the analytical framework to be used to evaluate application of the substitute-for-ordinary-income doctrine in this case.

The issue in Lattera involved the taxpayer's attempt to convert the character of lottery winnings from ordinary income into capital gains income by selling the right to receive the remaining future installments for a lump-sum payment. The court held that the lump-sum consideration was a substitute for what would otherwise be received in the future as ordinary income, so it should be taxed the same way.[6]

The Lattera court applied the substitute-for-ordinary-income doctrine developed under Hort and P.G. Lake, but acknowledged the potential to apply the principle too broadly since, theoretically, "all capital assets are substitutes for ordinary income." Lattera, 437 F.3d at 404. Noting that simply declaring that the court knows something is ordinary income when it sees it would be unhelpful to future litigants, the Third Circuit provided a method of analysis to apply the doctrine to determine the character of gains in future cases, recognizing "that any rule we create could not account for every contemplated transactional variation." Lattera, 437 F.3d at 405.

The substitute-for-ordinary-income analysis is to be undertaken under a "family resemblance" test, where the determination of the character of income is determined by reference to what the income most clearly resembles. To apply the test, the court identified assets known to be capital assets (stock and things that look and act like stock) and rights known to be ordinary income (rent and interest) and treated them as two categories on opposite poles of the analysis.

If an item does not bear a family resemblance to either pole, "like contracts and payment rights," an additional two factors are considered to properly categorize the "in-between transactions": (1) type of "carve-out"; and (2) character of asset. Lattera, 437 F.3d at 406.

A "carve-out" is in effect a "partial sale." A horizontal carve-out involves giving up a part of your interest in the property for a period of time (or a number of payments), but retaining the rest of the property so that you will have the whole of it after the carve-out ends. As examples of horizontal carve-outs, the court identified cases involving lottery winners that sold some of their future installments, but not all so that they retained a right for payments further in the future, and noted that Hort (term of years carved out of fee simple) and P.G. Lake (three-year payment right carved out of working interest in oil lease) both involved horizontal carve-outs. Lattera, 437 F.3d at 406-407.

[6] There have been several cases addressing this issue, all of which have held that the income was ordinary under the substitute-for-ordinary income doctrine. Womack v. Commissioner, 510 F.3d 1295 (11th Cir. 2007); Prebola v. Commissioner, 482 F.3d 610 (2nd Cir. 2007); Watkins v. Commissioner, 447 F.3d 1269 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Commissioner, 119 T.C. 1 (2002).

Generally, if there is a horizontal carve-out, when a taxpayer transfers an income right without transferring his entire interest in the underlying asset, the substitute-for-ordinary-income treatment should be applied. Id. at 407.

A vertical carve-out involves 'slicing off' of the taxpayer's rights, where the taxpayer sells his entire interest in the underlying asset without retaining any rights in the asset. Corporation A's Agreement B is not a vertical carve-out (Section B, below).[7] However, even if it was, the substitute-for-ordinary-income doctrine is not avoided simply by showing that the transaction involves a vertical carve-out since a vertical carve-out can result in either capital or ordinary income treatment. Id. Accordingly, if there is a vertical carve-out, the analysis proceeds to the next step: what is the character of the asset?

The character of the asset requires a determination of whether the asset represents a future right to *earn* income or a future right to *earned* income. "'Earned income conveys the concept that the income has already been earned and the holder of the right to this income only has to collect it. In other words, the owner of the right to earned income is entitled to the income merely by virtue of owning the property.'" Lattera, 437 F.3d at 408, quoting Thomas G. Sinclair, Comment, *Limiting the Substitute-for-Ordinary Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights*, 56 S.C. L.Rev. 387, 406 (2004).[8] Assets that represent a future right to earned income are treated as ordinary income.

"For the right to earn income, on the other hand, 'the holder of such right must do something further to earn the income…[because] mere ownership of the right to earn income does not entitle the owner to income.'" Id. Assets that represent a right to earn income receive capital gain treatment.

Application of the family resemblance test to the sale by the Latteras accordingly proceeds as follows:

> 1. The income does not bear a strong family resemblance to either end of the analytical spectrum;

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[7] The carve-out in United States v. Dresser Industries, 324 F.2d 56 (5th Cir. 1963) was a vertical carve-out. The Dresser case is another case involving patents connected to oil drilling. In that case, the consideration received by the licensee for transferring back to the patent holder the exclusivity feature it had under its license was treated as capital gains. The Fifth Circuit distinguished the case before it from that in Halliburton because the taxpayer in its case did not have a right to sublicense the license and only had the relinquished exclusivity feature. The exclusivity feature, by itself, could not be used to generate ordinary income, so the consideration received for the exclusivity feature was not a substitute for ordinary income that could be generated by the relinquished right.

[8] See also Leslie B. Snyder, Taxation with an Attitude: Can We Rationalize the Distinction between "Earned" and "Unearned" Income?, 18 Va. Tax Rev. 241 (1998)

2. There was a vertical carve-out in that the Latteras sold all of the right to all of their remaining lottery payments; and

3. The right to the lottery payments is a right to earned income because the Latteras did not have to do anything further to acquire the income, the payments would continue to arrive simply due to ownership of the asset.

Accordingly, the substitute-for-ordinary-income doctrine applied, and the lump-sum payment was taxed as ordinary income. Lattera, 437 F.3d at 409-410.

In this case, when Corporation A and Corporation G amended their agreement in Year 1, the monies received were a substitute for the royalties that Corporation A was to receive under the license and sublicense with Corporation G. All Corporation A had to do to receive the royalty income was to remain a party under the license and sublicense with Corporation G, as well as the licensee under the contract with Corporation B. The income, as to Corporation A, was earned and Corporation A just had to wait to receive it under the Agreement A. After the Agreement B, Corporation A received $Amount 15 up-front and did not have to wait as long for the royalties measured by sales.

Section B
The Agreement B Failed to Effect a Sale
of Device A , Patents, Know-How or the Agreement C

In order for an agreement transferring interests in patents or unpatented know-how to be treated as a sale of the patents or know-how[9] for tax purposes, six factors (supported by the law discussed below) must be considered:

1. Whether there was a clear and unmistakable intent at the time of the transaction to transfer all right, title and interest in the patents and know-how. If the requisite intent is not present, the agreement is a mere license of the patents and know-how, not a sale.

2. Whether the taxpayer owned the property it purported to sell. The taxpayer must own what it purports to sell. If the patents and know-how are not owned by the seller, the agreement cannot sell either the patents or the know-how.

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[9] Unpatented know-how that rises to the level of property for tax purposes is treated similarly to patents except that the transfer must be in perpetuity. Pickren v. United States, 378 F.2d 595 (5th Cir. 1967) (transfer of know-how for 25 years was not a sale because the know-how could have a life longer than 25 years, know-how had to be transferred in perpetuity); Taylor-Winfield Corp. v. Commissioner, 57 T.C. 205 (1971), aff'd 467 F.2d 483 (6th Cir. 1972). See Rev. Rul. 71-564, 1971-2 C.B. 179 (unqualified transfer of the exclusive right to use a trade secret, know-how, until it becomes public knowledge and no longer protectable under the laws of the country where the transferee operates is a transfer of property under section 351 of the Code).

3. Whether applicable tax doctrines preclude sale treatment.

4. Whether the agreement is unambiguous and, in form, a license. If unambiguous and, in form, a license, the agreement cannot be altered by extrinsic evidence and the taxpayer must be held to the form of its own agreement.

5. Whether the agreement is ambiguous or is in form a sale. If ambiguous or, in form, a sale, to be a sale for tax purposes, the characteristics of the transaction must be such that, in legal effect, patent law would recognize the transaction as an assignment.

6. Whether the taxpayer retained substantial rights in the patents or know-how. If substantial rights were retained, the agreement is a mere license, not a sale.

Each of these factors is addressed below, first setting forth the law then applying the law in light of the terms of the Agreement B as it modified the Agreement A. Based on the applicable law, the Agreement B cannot effect a sale of any patents or any know-how (including the sale of the Device A). Should Corporation A contend it sold the Agreement C rather than patents or know-how, the law and facts addressed after factor 6 establish that Corporation A could not, and did not, sell the Agreement C.

Section B, Factor One: Corporation A lacked the Requisite Intent to Effect a Sale of the Patents and Know-How the Subject of the Agreement B

For a transfer of an interest in a patent or know-how to be accorded sale treatment for tax purposes, there must be a clear and unmistakable intention on the part of the transferor to part with all right, title and interest in the property at the time of the transfer. Many cases rely on, reiterate and apply this proposition of law. In McDermott v. Commissioner, 41 T.C. 50 (1963), the taxpayer and his wife entered into a series of agreements and waivers under which they claimed they sold their patents to their wholly-owned corporation. The required clear intent to surrender all interests in their patents was held to be lacking. The taxpayers' agreements and actions to maintain control of the patents belied the claimed intent to surrender all of their interests in the patents. Kronner v. United States, 110 F. Supp. 730 (Ct. Cl.1953),[10] emphasized the necessity of a clear intent to relinquish all interests, quoting the reasoning in Eterpen Financiera Sociedad De Responsabilidad Limitada v. United States, 108 F. Supp. 100, 104 (Ct.Cl. 1952), cert denied, 346 U.S. 813 (1953):

[10] Kronner was cited with approval by Congress for its treatment of patent transfers that would not be within the safe harbor that Congress was enacting, codified at I.R.C. § 1235. S. Rep No. 83-1622, *as reprinted in* 1954 U.S.C.A.N. 4621 at 5082. Pursuant to §1235(b), a C corporate transferor is not within the § 1235 safe harbor. Pursuant to Treasury regulation, for transfers that are not within § 1235, "section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset." Treas. Reg. § 1.1235-1(b).

> " It is true that a license to make, use, and vend a patented device gives rise to an assignment of a patent where the document granting such a license is consistent with a present intent by the owner to transfer the patent. *If however, there are present in the license agreement itself, or in some closely related document which must be considered a part of the same transactions, factors which expressly negative [sic] the intent to make a transfer of the patent, the transaction cannot be held the equivalent of an assignment.*"

110 F. Supp 730, 734-735, quoting Eterpen Financiera Sociedad De Responsabilidad Limitada v. United States, 108 F. Supp. 100 (Ct. Cl. 1953) (emphasis added).

The Kronner court then stated "We believe this to be the correct test to be applied in these situations." 110 F. Supp. at 735. In Eterpen, the Court specifically commented it was difficult to believe the taxpayer's current contentions of intent to sell since:

> [i]f such had been the taxpayer's intention at the time the agreements were drafted, the same result could have been achieved far more clearly and by …much less cumbersome means.

108 F. Supp. at 105.

That same comment applies here, as the law requires the intent be present at the time of the transaction. See pages 51-54 below (additional cases holding a transferor to the words in its agreement that "negative" its assertion that the requisite intent was present at the time of the transaction). Corporation A is a sophisticated taxpayer; . It is familiar with what it takes to evidence a purchase or sale, as demonstrated by

At no place in the Agreement B did Corporation A include language that indicated an intent to sell all right, title, and interest in the know-how and patents that were the subject of the Agreement B; rather, the Agreement B evidenced Corporation A's clear intent to retain rights and controls as a licensor. For example, if Corporation A had intended to sell the patents, it could have, and should have, included language to the effect that it was assigning the rights to make, use and sell the patents for the lives of the patents, and assigning the rights to make use and sell the know-how in perpetuity. The absence of such language speaks volumes; Corporation A did not intend to sell the Device A, patents or know-how to Corporation G.

In the Agreement B, Corporation A did not even make the license exclusive as to itself. Corporation B, in the Agreement C, made the license grant exclusive, even as to itself, stating:

Agreement C, Article # , Grant, § ## .

In determining that the words clearly establish the intent to retain ownership and control, one has to start with the Agreement A. There can be no doubt that the plain language within the four corners of the Agreement A affirmatively, clearly and unambiguously established that the Agreement A is a mere license and sublicense. The Amount 12 "Whereas" clause provides that Corporation A agreed to grant a license and a sublicense. Section ## of the Agreement A clearly grants a license and sublicense.[11] The Agreement B neither replaces the Agreement A (Agreement B, § ##) nor repudiates the clear limitation to a grant of a license and sublicense. The Agreement B merely added a paragraph to the grant to retain the right to commercialization of Product to Use C. (Agreement B, § ##) The clear indication from within the four corners of the Agreement B is that there was no intent to convert the Agreement A into a sale of the licensed and sublicensed patents and know-how.

The Agreement B is an Amount 10 page document that clearly identifies each and every section of the Agreement A that it modified. The language is clear and unambiguous and none of it states that Corporation A is selling the patents and licenses. All rights to use the patents and know-how are still carefully circumscribed and subject to the Agreement C. Corporation A, in effect, concedes the Agreement B did not alter the licensed rights to the Device A, patents or know-how when it did not seek, and represents it did not need, Corporation B's approval of the amendment. Corporation A is bound by the terms of its Agreement B. Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), cert. denied, 389 U.S. 858 (1967). Extrinsic evidence cannot be used to create an ambiguity that is not apparent on the face of the document. United States v. Donovan, 348 F. 3d 509, 512 (6th Cir. 2003). Even if extrinsic evidence were admissible, the objective evidence clearly establishes that Corporation A continued to use the Device A, patents and know-how for its own research and development and to file patent applications. See footnotes in "Fact" section (addressing patent applications Corporation A continued to file). See also Exhibit A, Timeline (Date 53 patent filings by Corporation A).

The clear and unambiguous language within the four corners of the Agreement B modifying the Agreement A, indicates Corporation A lacked the requisite intent to part with all right, title and interest in the patents and know-how. Corporation A intended to, and did, continue to license and sublicense the patents and know-how.

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Section B, Factor Two: Corporation A Did Not Own Corporation B's Patents and Know-How and Could Not Sell What It Did Not Own

One cannot sell what one does not own. United States Mineral Products Co. v. Commissioner, 52 T.C. 177, 195 (1969), acq., 1969-2 C.B. XXIII, 1969 WL 99658 (transferor which had limited rights in patents because patent holder did not transfer his whole interest could not sell the patents; the patents could only be licensed, because the transferor could convey no greater rights than it possessed). There are also patent cases that unequivocally state one cannot sell what one does not own. See Prima Tek II, LLC v. A-Roo Co., 222 F.3d 1372, 1382 (Fed. Cir. 2000)("an owner of a license cannot convey that which it does not own.") and TransCore, LP, *et al*. v. Electronic Transaction Consultants Corp., 563 F. 3d 1271, 1275 (Fed. Cir. 2009)("[O]ur analysis begins with the premise that one cannot convey what one does not own. This principle is particularly important in patent licensing, as the grant of a patent does not provide the patentee with an affirmative right to practice the patent but merely the right to exclude.").

Thus, to apply this second factor, what Corporation A owned must be considered. Corporation A did not own Corporation B's Device A, patents or know-how. Indeed, Corporation A does not even contend that the Agreement C sold said intellectual property to Corporation A. If Corporation A did so contend, it would err, *e.g*., Corporation A did not even have the right to make the Device A. The license grant for both the patents and know-how in the Agreement C is very circumscribed, with Corporation B retaining ownership of its own patents, know-how and Device A (as addressed in the fact section, above). While the license is exclusive even as to Corporation B for the Territory B, the grant to Corporation A is limited to a license. (Agreement C, Article Grant) Accordingly, Corporation A cannot sell Corporation B's Device A, patents or know-how because it does not own the intellectual property; Corporation A can only sublicense the property that Corporation B licensed to Corporation A.

Section B, Factor Three: Applicable Tax Doctrines

Acceleration of payments required by a contract does not provide basis for the recharacterization of a transaction as a sale for tax purposes. Rather, the substitute-for-ordinary-income doctrine applies to preclude changing the character of the income to capital. There are other tax doctrines that exist, but the only other one of potential application here is substance over form. Had the form of the Agreement B been that of a sale, the substance would not be a sale since patent law would not recognize the Agreement B as assigning the patents (as discussed below).

Section B, Factors Four and Five: Corporation A Did Not Sell Any of the Patents <u>or Know-how the Subject of the Agreement B that Corporation A Did Own</u>

In order to apply Factors 4 and 5, it is important to know what a patent is and what patent law provides.[12] Patents are federal statutorily-created monopolies allowing the patent holder to exclude others from using, making or selling. <u>Bloomer v. McQuewan</u>, 55 U.S. 539, 549 (1852) (A patent grants the patentee "the right to exclude everyone from making, using or vending [selling] the thing patented, without the permission of the patentee."); <u>Sola Electric Co. v. Jefferson Electric Co.</u>, 317 U.S. 173 (1942) (federal law pre-empts any state anti-monopoly challenge to patents); <u>Vaupel Textilmaschinen KG v. Meccanica Euro Italia S.P.A.</u>, 944 F.2d 870, 875 (Fed. Cir. 1991) (a patent provides its owner with the right to exclude others from using, making and selling the claimed invention); <u>Rail-Trailer Co. v. ACF Industries</u>, 358 F.2d 15, 16-17 (7th Cir. 1966) (a patent is not an unlawful restraint of trade).

Whether an agreement transferring an interest in a patent is an assignment (sale) of the patent or merely a license to use the patent is a question of federal patent law. In <u>Crown Die & Tool Co. v. Nye Tool & Machine Works</u>, 261 U.S. 24, 33 (1923), the Supreme Court rejected the petitioner's contention that an asserted assignment of a patent was merely a question of contract law, opining that the question of "the validity of the assignment of a patent . . . is a question arising under the patent laws. . . " 261 U.S. at 33. The court stated the patentee has a common law right to make, use and vend its own invention, but the right to exclude is statutory, reasoning that if

> the patentee retains the right to make, use and vend, but gives to many different individuals the right to sue certain named infringers, respectively, and that with the sole motive of harassing them such as is avowed in the recitals of the instrument before us. If held legal, it would give the patentee an opportunity without expense to himself to stir up litigation by third persons that is certainly contrary to the purpose and spirit of the statutory provisions for the assigning of patents.

261 U.S. at 39.

<u>Crown Die & Tool</u> concluded "the right to exclude others conferred in a patent can only be conferred upon one who has the common law right to use, make and vend." 261 U.S. at 39. <u>Crown Die & Tool</u> stated, in agreement with a prior United States Supreme Court opinion,

> "*The monopoly did not exist at common law*, and the rights, therefore, which may be exercised under *it, cannot be regulated by the rules of the common law.* It is created by the act of Congress; and *no rights can be*

[12] As addressed in footnote 39, unpatented know-how that rises to the level of property for tax purposes is treated as are patents, except that the transfer must clearly be in perpetuity with the know-how not reverting to the transferor when the agreement terminates by its natural term.

> *acquired in it unless authorized by statute, and in the manner the statute prescribes*."

261 U.S. at 40, quoting Gayler v. Wilder, 10 How. 477, 494 (emphasis added).

Tax cases recognize the important role of federal patent law in determining if a patent is licensed or assigned (sold). In Kronner, the court opined that whether a patent agreement met the "sale or exchange" requirement of tax law must be resolved in light of patent law because the necessary terms for a sale of a patent "have become peculiar to the patent field." Kronner, 110 F. Supp. at 734.

The Kronner court cited Crown Die & Tool Co. v. Nye Tool & Machine Works, 261 U.S. 24 (1923), and stated that tax law should follow Crown Die & Tool, first quoting from said case and then stating, respectively, as follows:

> Patent property is the creature of statute law and its incidents are equally so and depend upon the construction to be given to the statutes creating it * * *. It is not safe therefore, in dealing with a transfer of rights under the patent law to follow implicitly the rules governing a transfer of rights in a chose in action at common law.
>
> Recognition of this distinction must be made when construing agreements transferring patent rights.

110 F. Supp. 730 at 734.

The critical importance of federal law relative to other laws for addressing patent issues was emphasized in Bonito Boats v. Thunder Craft Boats, 489 U.S. 141, 152 (1989), wherein the Court stated "our past decisions have made clear that state regulation of intellectual property must yield to the extent that it clashes with the balance struck by Congress in our patent laws," and held a state statute conflicting with federal patent policy was pre-empted by the supremacy clause.[13]

Thus, what can constitute an assignment (sale) under patent law must be understood to determine the tax consequences of a written instrument transferring an interest in a patent. The landmark case of Waterman v. Mackenzie, 138 U.S. 252 (1891), interpreted the federal statutorily-granted monopoly law as requiring that the right to use, make and sell be transferred to constitute an assignment (sale) of the patent (the Waterman Rule). The Supreme Court opined:

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[13] A discussion of the reasoning behind preemption can be found in Bonito Boats wherein the Supreme Court addressed Article I, § 8, cl. 8 of the United States Constitution (patent clause), what is patentable and what is not, and preemption by silence or otherwise. The Supreme Court noted it was aware of the scholarly and judicial debate on the pre-emptive sweep of Supreme Court decisions.

> Every patent issued under the laws of the United States for an invention or discovery contains "a grant to the patentee, his heirs and assigns, . . . of the exclusive right to make, use, and vend the invention or discovery throughout the United States and the territories thereof." *The monopoly thus granted is one entire thing, and cannot be divided into parts, except as authorized by those laws*. The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st, the whole patent, comprising the exclusive right to make, use, and vend the invention throughout the United States; or, 2d, an undivided part or share of that exclusive right; or, 3d, the exclusive right under the patent within and throughout a specified part of the United States. A transfer of either of these three kinds of interests is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself, with a right to sue infringers. In the second case, jointly with the assignor. In the first and third cases, in the name of the assignee alone. *Any assignment or transfer, short of one of these, is a mere license*, giving the licensee no title in the patent . . . .

138 U.S. at 255 (citations omitted) (emphasis added).

Waterman required that the transfer of the rights be exclusive, *i.e.*, other third parties could not exercise these rights. This is so, even as to the patentee/transferor. 138 U.S. at 256, 260. In addition, the right to sue for infringement must be transferred. 138 U.S. at 255. While no particular form is required to assign a patent, the agreement assigning patent rights must be reduced to writing, and to be valid against third parties without notice, timely filed in the United States Patent and Trademark Office (USPTO). Id. Waterman stated that "[w]hether a transfer of a particular right or interest under a patent is an assignment or a license does not depend upon the name by which it calls itself, but upon the legal effect of its provisions." 138 U.S. at 256. Waterman stated that a condition subsequent will not defeat the effect of an assignment "when there is no express stipulation to the contrary." 138 U.S. at 258.

Accordingly, pursuant to the Waterman Rule, in order for the legal effect of an agreement transferring interests in a patent to be an assignment (sale) of the patent:

1. The transfer must be exclusive, even as to the transferor;

2. The right to sue infringers must be transferred; and

3. The transfer must assign either

   a. the whole patent, comprising the exclusive right to make, use, and sell the invention throughout the United States;

   b. an undivided part or share of each of the exclusive rights (to make, use, and sell); or

   c. all three exclusive rights (to make, use and sell) within and throughout a specified part of the United States.

Otherwise, the transaction is a mere license. This rule of law has been applied since the 1800s in many contexts (including patent cases, preemption cases and tax cases) to determine whether a transaction transferring interests in a patent can be accorded assignment (sale) treatment.

A year after the Waterman opinion, in Pope Manufacturing Co. v. Gormully & Jeffery Manufacturing Co. *et. al.*, 144 U.S. 248 (1892),[14] the Court addressed whether the Waterman Rule extends to situations wherein a patentee attempts to assign parts of its patent to different persons. The Court stated that the issue:

> really involves the question, which *is one of considerable importance, whether a patentee can split up his patent into as many different parts as there are claims and vest the legal title to those claims in as many different persons.* This question has never before been squarely presented to this court, but, in view of our prior adjudications, it presents no great difficulty.

144 U.S. at 250 (emphasis added).

After reviewing Gayler v. Wilder, 51 U.S. 477 (1850) and Waterman, the Pope Manufacturing Co. court then opined:

> We see no reason to qualify in any way the language of these opinions. While it is sometimes said that each claim of a patent is a separate patent, it is true only to a limited extent. . . [I]t might lead to very great confusion to permit a patentee to split up his title within the same territory into as many different parts as there are claims. If he could do this, his assignees would have the same right they now have to assign the title to certain territory, and the legal title to the patent might thus be distributed among a hundred persons at the same time. Such a division of the legal title would

[14] This Pope Manufacturing Co case (144 U.S. 248 (1892)) should not be confused with the cases of the same name at 144 U.S. 224 (dealing with an equity issue relative to a license that extended longer than the patent), 144 U.S. 238 (dismissing on infringement claim), and 144 U.S. 254 (addressing patentability).

> also be provocative of litigation among the assignees themselves as to the exact boundaries of their respective titles.

144 U.S. 248 at 252.

The Supreme Court then held the so-called assignment of the claim a mere license. See Lucent Technologies v. Gateway, 543 F. 3d 710, 721 (Fed. Cir. 2008) (confirming Pope Manufacturing is current law and "stands for the proposition that the owner of a patent cannot split up ownership rights in a patent and assign different claims to different parties").

As is clear from the above cited cases and as stated in Crown Die & Tool Co, above, quoting from Chief Justice Taney's opinion in Gayler v. Wilder, 51 U.S. 477(1850)

> "[I]t was obviously not the intention of the legislature to permit several monopolies to be made out of one, and divided among different persons . . . "

261 U.S. 24 at 38.

The tax cases that ignore Waterman as merely procedural fail to properly apply well-established Supreme Court substantive law relative to patents. For example, Merck & Co. v. Smith, 261 F.2d 162, 165 (3rd Cir. 1958), dismissed Waterman as an infringement standing case which "does not determine either way the effect of an attempt at transfer of an intangible right in a patent," holding a claim in a patent could be sold.[15] Merck failed to consider Pope Manufacturing; rather, Merck reasoned by analogy to United States v. Carruthers, 219 F. 2d 21 (9th Cir. 1955), and a number of lower court opinions to find a claim in a patent could be sold separately.

Merck's assertion that a claim in a patent can be sold separately is in direct conflict with both the reasoning and holding of the United States Supreme Court in Pope Manufacturing. In 2008, the Federal Circuit, which has exclusive jurisdiction of patent appeals, asserted Pope Manufacturing "stands for the proposition that the owner of a patent cannot split up its ownership rights in a patent and assign different claims to different parties." Lucent Technologies, 543 F. 3d at 721. Merck cannot, *sub silento*, overrule Pope Manufacturing; Lucent Technologies forecloses misinterpreting or ignoring the proposition for which Pope Manufacturing stands.

Carruthers, relied on by Merck, is often cited for the proposition that a field of use can be sold (Carruthers did not address selling claims). Carruthers actually hedged its opinion by stating **if** Waterman applied, because the lower court found the retained rights had no value, nothing was retained so the rights to make, use and sell in all fields

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[15] The Merck court, contrary to Waterman, asserted the right to sue infringers did not have to be transferred. 261 F. 2d at 165.

were, in effect, transferred as required by Waterman. Thus, for purposes of appeal, Carruthers is more in the nature of a fact-based case that found the required characteristics for a sale were, in fact, present based on value; not a case that held as a matter of law that a field of use in a patent could be sold.

E.I. du Pont de Nemours and Co. v. U.S., 432 F.2d 1052 (3rd Cir. 1970), also cited by some for the proposition a field of use can be sold for tax purposes, actually affirmed the District Court's valuations of the retained rights (Dacron rights, among others) as having no substantial value, using a clearly erroneous standard. 432 F. 2d 1055-58. Thus, du Pont, as Carruthers, is more in the nature of a fact-based valuation case. However, in what is *dicta* given the affirmation of the valuation findings, du Pont stated that for capital gains purposes, a patent is divisible among industries and uses. While du Pont did cite to Waterman, E.W. Bliss and Pope Manufacturing, it dismissed them as non-controlling procedural law. 432 F.2d at 1057. There was no discussion of, or justification for, permitting several monopolies to be created out of the sole statutorily-granted monopoly notwithstanding federal patent policy and the United States Supreme Court holding in Pope Manufacturing. Instead, du Pont relied on a case in which the Commissioner non-acquiesced, Rouverol v. Commissioner, 42 T.C. 186 (1964), non-acq. 1965-2 C.B. 7; a New Jersey district court case with questionable reasoning;[16] the valuation cases of Carruthers and Estate of Laurent v. Commissioner, 34 T.C. 385 (1960), non-acq. 1961-2 C.B. 6;[17] and a case that was subsequently reversed, Fawick v. Commissioner, 52. T.C. 104 (1969), rev'd, 436 F.2d 655 (6th Cir. 1971), non-acq. 1978-2 C.B. 3. [18]

[16] In First National Bank of Princeton v. United States, 136 F. Supp. 818 (D. N.J. 1955), the court rejected every indication of a license: the court analogized patent transfers to real estate transfers, contrary to the United States Supreme Court cases that require transfers of the statutorily-granted monopoly to be analyzed pursuant to the federal statute; the court ignored that the transferor retained the right to use, contrary to the Waterman Rule; and the court rejected the government's argument that the retention of a field of use precludes sale treatment, asserting the monetary value of the retained rights was highly speculative.

[17] In Estate of Laurent a widow petitioned for capital gain treatment for her deceased husband's transaction. The court specifically stated the issue was factual. 34. T.C. 385, 397. The Court then found that the decedent had transferred all rights of value as in Carruthers.

[18] In reversing the Tax Court in Fawick, the Sixth Circuit held "that in order for the income from the transfer to qualify for § 1235 treatment, the transfer must cover all practical fields-of-use." 436 F.2d at 663. The Sixth Circuit characterized du Pont as a valuation case where the retained fields had no value (436 F.2d at 663), unlike Fawick where the retained field had value. While Fawick is a § 1235 case so it is not determinative for transfers outside the scope of § 1235, as are corporate transfers, the Sixth Circuit closed its opinion by specifically stating "[w]e agree with the reasoning of Redler Conveyor Co. . . ." 436 F. 2d at 665. Redler Conveyor Co. v. Commissioner, 303 F. 2d 567 (1st Cir. 1962) was not a § 1235 case, with the Redler Conveyor court declining to allow a field of use transfer to be treated as a sale. 303 F. 2d 567 at 569.

The opinions in Gayler, Waterman, Pope Manufacturing Co., Crown Die & Tool Co. and Lucent Technologies indicate that tax cases that dismiss United States patent law as mere procedural law that has no impact on the question of whether a transaction can be treated as a sale for tax purposes are in error. They stand in contrast to tax cases in which courts held that there was a sale, even though the transferor retained a field of use, because, as a matter of fact, the courts determined that the retained field of use did not have any value. Under all the facts and circumstances in those cases, the federal statutorily-granted monopoly had not been split. Accordingly, these tax cases do not reject federal patent law as irrelevant and do not hold the propositions in Waterman and Pope Manufacturing can be disregarded; rather, the cases are narrow, fact-based, determinations. Narrow construction of such cases is necessary because, although it appears that field of use transfers have not yet been opined upon by the United States Supreme Court or the Federal Circuit, field of use transfers could lead to the same multiplicity of suits as the transfer of individual claims of a patent

For transfers where a field of use is retained, the taxpayer has the burden to establish the retention of the field of use was not a substantial right in light of the facts and circumstances and to establish the retained field lacked fair market value at the time of the transfer. Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." [19] The taxpayer's burden is not carried by mere uncorroborated statements that there is no value or opaque assertions of complexity that are not supported by valuations of the retained rights. See Young v. Commissioner, 269 F. 2d 89, 93 (2nd Cir. 1959) (the transferor failed to carry its burden of proof to establish the retained rights are not substantial and had no value).

See Waterman,138 U.S. 252 at 260 (benefits of registering).

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[19] Bank One v. Commissioner, 120 T.C. 174, 303 (2003), aff'd in part, vacated in part, remanded, sub nom J. P. Morgan Chase & Co. v. Commissioner, 458 F. 3d 564 (7th Cir. 2006, aff'd 530 F. 3d 634 (7th Cir. 2008) ("The term "fair market value" is used throughout the Internal Revenue Code, but has never been defined by Congress. (footnote omitted) The Treasury Department has defined the term for Federal income tax purposes as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs.; see also sec. 1.704-4(a)(3), Income Tax Regs. (similar definition). See generally Rev. Rul. 59-60, sec. 2.02, 1959-1 C.B. 237. The Treasury Department has prescribed a similar definition for Federal estate tax and gift tax purposes. See § 20.2031-1(b), Estate Tax Regs.; § 25.2512-1, Gift Tax Regs.")

In determining whether an agreement involves the license or sale of a patent, the language in the agreement must be considered to determine the legal effect of a transaction for patent or tax purposes given the Waterman statement that labels do not control. In E.W. Bliss Co. v. United States, 253 U.S. 187 (1920), the Supreme Court relied on Waterman and clarified what Waterman meant when it stated the label was not controlling as follows:

> While the legal effect of the terms used, and not the name applied to the instrument containing them, will determine whether a transfer is an assignment or a license, nevertheless *the language used is often, as in this case, of great significance in determining what that legal effect shall be.*

253 U.S. at 192 (emphasis added)

In E.W. Bliss, the Court considered that the contract at issue was termed a license and did not grant exclusive territorial rights, only rights with respect to the United States government with the licensor to bring any necessary suit for infringement. The Court held "[p]alpably this is a mere license, not sufficient to sustain a suit for infringement." 253 U.S. at 193. Thus, it is error to interpret the Waterman language relative to the fact that the label does not control as meaning the language in the agreement can be ignored.

Many other cases support the proposition that the terms of agreement impact the determination whether a transaction is a sale or a license and must be considered. The plain language of the agreement was relied upon in Kronner, 110 F. Supp. 730 at 734 (" the best evidence of this intention is the very words used in the contract."), and Commissioner v. Hopkinson, 126 F.2d 406, 410 (2d Cir. 1942), nonacq. withdrawn, acq. 1962-2 C.B. 3 ("Their intention, as shown by their language in the contract, was to have the 'seller' sell and the 'purchaser' buy the property."). In Commissioner v. Celanese Corp., 140 F. 2d 339 (D.C. Cir. 1944), the court held the transaction to be a sale, relying on the use of the terms in the contract, such as "purchaser" and "vendor [seller]". The Court explicitly stated the intent to sell was confirmed by "unmistakable language" in the agreement. 140 F. 2d at 341. All three of these cases that relied on the terms used in the agreement to support characterizing the transaction as a sale or license were cited with approval by Congress. S. Rep. No. 83-1622, *as reprinted in* 1954 U.S.C.C.A.N. 4621 at 5082.

Redler Conveyor Co. v. Commissioner, 303 F. 2d 567 (1st Cir. 1962), held that clear and unambiguous agreements licensing intellectual property cannot be recharacterized as sale agreements (relying, in part, on E. W. Bliss Co. v. United States, 253 U.S. 187 (1920)). The Redler Conveyor court stated:

> The agreements show every evidence of careful and skillful draftsmanship. And they are licenses in form in that the parties are

> described as licensor and licensee and the payments to be made under them are called royalties. *Substance controls words to be sure, but when parties obviously skilled in the business at hand use words of art in formal documents carefully drawn, we can only assume that the words used were intended to mean what they say.* We can hardly assume that their use was inadvertent or the product of bumbling draftsmanship.

303 F.2d at 569 (emphasis added).

The Sixth Circuit, in Switzer v. Commissioner, 226 F. 2d 329, 330 (6th Cir. 1955), found that the use of the word "exclusive" as a modifier did not render a contract ambiguous where the agreement was titled "Memorandum of License Agreement" and referred to the parties as "licensor" and "licensee" and provided that the licensee should forward royalties from sublicenses to the licensor. The court stated:

> Petitioners' contention that the transaction was essentially an assignment or sale of the licenses to the corporation is based principally upon the following provision in the Agreement: 'Licensee is exclusively licensed in the United States and foreign countries to make, use and sell and to grant sub-licenses to make use and sell products, devices and methods within the scope of all patents * * * now owned by Licensors * * *.' It has been held that an agreement transferring to another the exclusive right to make, use and sell for the life of the patent constitutes an assignment. . . . that whether the instrument constitutes an assignment or a license does not depend upon the name by which it is called, but upon the legal effect of its provisions.
>
> However, it is also the rule that while *such words in a license* agreement give rise to an assignment of a patent where the document granting such a license is consistent with a present intention by the owner to transfer the patent, they *can not be held the equivalent of an assignment where the document itself and the total factual complex surrounding the transaction negatives [sic] such a transfer. Although no particular form is required for an assignment, the instrument of transfer must be unambiguous and show a clear and unmistaken intent to part with the patent.*

226 F.3d at 330 (emphasis added)(citations omitted).

The agreement at issue in Switzer was held to be a license, making it clear that just the use of the term "exclusive" does not evidence intent to sell and cannot be the touchstone for treating a license as a sale. As stated in Rail-Trailer Co. v. ACF Indus., 358 F.2d 15 (7th Cir. 1966), with respect to exclusivity provided in transactions transferring interests in a license:

> [A] patentee may, *without divesting himself of ownership of the patent*, grant an exclusive license for the manufacture of the patented device, which license serves to exclude the patentee himself from engaging in the manufacture of the device.

358 F.2d at 16-17 (emphasis added).

Accordingly, not only can the words of the agreement be considered, the words must be considered and found to clearly and unmistakably evidence the intent to part with all right, title and interest in the patent, with contract construction principles applicable to ascertain the import of the agreement in conjunction with patent law requirements.[20] US v. Donovan, 348 F. 3d 509, 512 (6th Cir. 2003), summarized general contract interpretation principles as follows:

> The question of whether the language of an agreement is ambiguous is a question of law. Once the language of a contract has been held to be ambiguous, the interpretation of such language is a question of fact that turns on the intent of the parties. A court, however, may not use extrinsic evidence to create an ambiguity; the ambiguity must be "apparent on the face of the contract. "

348 F. 3d at 512 (citations omitted).

If the agreement is unambiguous, extrinsic evidence is not admissible to vary the terms.[21] However, even if an agreement unambiguously asserts the patents are sold,

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[20] See Pfizer Inc. v. Elan Pharmaceutical Research Corp., 812 F. Supp 1352, 1359-62, 1371-75 (D. Del. 1993) (Pfizer sued for infringement based on, *inter alia,* the conduct of clinical trails, but the court granted summary judgment finding Pfizer lacked standing to sue as a mere licensee by applying contract construction principals in conjunction with the Waterman Rule, stating extrinsic evidence was unnecessary when the language was clear) .

[21] In Alliant Techsystems, Inc. v. United States, 74 Fed. Cl. 566, 576-577 (2007), when interpreting the terms of a settlement agreement regarding to payments from a pension plan, the Federal Court of Claims held that where the language of a contract is clear and unambiguous "the words of those provisions must be given their plain and ordinary meaning by the court in defining the rights and obligations of the parties. Hyman Constr. Co. v. United States, 832 F.2d 574, 579 (Fed. Cir. 1987) (quoting Elden v. United States, 617 F.2d 254, 223 Ct. Cl. 239, 252 (1980)); accord McAbee Constr., Inc. v. United States, 97 F.3d 1431, 1435 (Fed. Cir. 1996). Therefore, if the contract is clear on its face, this court's interpretation of the contract is at an end. McAbee Constr., Inc., 97 F.3d at 1435." Put another way, "[w]hen the contract language is unambiguous, the court's inquiry is at an end, and the plain language of the contract controls." Kerin Motors, Inc. v. United States, 80 Fed. Cl. 679, 684 (2008). See also W.B. v. Matula, 67 F.3d 484 (3d Cir. 1995); Hullett v. Towers, Perrin, Forster & Crosby, Inc., 38 F.3d 107 (3d Cir. 1994). A federal bankruptcy court recently wrote: "extrinsic evidence cannot be admitted or considered to add to, subtract from, vary or contradict written contracts that are valid, complete, and unambiguous, and not affected by accident, fraud or mistake. In re Paragon Trade Brands, Inc., 324 B.R. 797 (Bankr. N.D. Ga. 2002), aff'd, 278 Fed. Appx. 1000 (11th Cir. 2008).

the agreement will not be treated as an assignment for patent purposes if the substance of the transaction is not an assignment. For example, if the agreement does not transfer the rights as required by the Waterman Rule, the agreement will not be characterized as an assignment.

The cases discussed above clearly establish that sophisticated parties can be held to their plain and unambiguous agreements, except in situations where the purported sale cannot be accorded sale treatment because the legal effect is precluded by patent law. Those cases also establish that when the plain language of the parties' unambiguous agreement shows an intent to enter into a license (thus negating the requisite intent to transfer all right, title and interest in a patent) and the agreement is, in form, a license, it is treated as a license, absent compelling reason to reject the license form.[22] Accordingly, if an agreement is unambiguous and, in form a license, the Commissioner can hold the taxpayer to the form of its agreement. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992). If a taxpayer seeks to repudiate the form of its own agreement, it generally bears an increased burden,

Corporation A is a sophisticated party, and should be held to the terms of its agreements. The Agreement B does not assert that patents or know-how were being sold or assigned; it does not modify the Agreement A's grant of licenses and sublicenses. Moreover, the Agreement B is still subject to the Agreement C. Corporation A's assertion that it did not need to seek Corporation B's approval for the Agreement B is an implicit admission that the Agreement B is a license as is the Agreement A. If the Agreement B involved a sale, Corporation B's agreement to the amendment would have been sought. Corporation B's approval was not sought because the amendment merely accelerated the payments already due without changing the respective parties' rights to the patents or know-how.

The Agreement B did not even make the continuing license and sublicense of the patents and know-how exclusive as to Corporation A, as required to effect a sale of the

[22] An example of a case where a document, in form, a license might be treated as an assignment is Biosynexus v. Glaxo Group Ltd. and Medimmune, 836 N.Y.S. 2d 126 (N.Y. App. Div. 1st Dept. 2007), wherein an unreported opinion of the lower court (2006 WL 624896) was affirmed as modified (to clarify the injunction granted). Biosynexus alleged in its brief (Brief for Plaintiff-Respondent Biosynexus, Inc., Biosynexus, Inc. v. Glaxo Group, Ltd., *et al*., 2006 WL 4516718, No. 2006-08728 (April 19, 2006)) that, *inter alia,* Glaxo styled its agreement with MedImmune as a license to circumvent the provisions of the Biosynexus-Glaxo collaboration agreement that precluded assignment. Glaxo, in its brief (Reply Brief for Defendant\Appellant Glaxo Group, Biosynexus, Inc. v. Glaxo Group, *et al*., 2006 WL 4516719, No. 2006-08728 (April 28, 2006)), argued the lower court improperly imported federal patent law on standing to bring a federal patent infringement claim to resolve the issue of whether the Glaxo-MedImmune agreement was a sale agreement, and failed to take into account there was no novation. The appellate court found that Biosynexus was likely to prevail on its arguments, as had the lower court, and upheld the lower court's reliance on Waterman and grant of an injunction, as modified.

patents. See Crown Die & Tool (rejecting recognition as an assignment when the transferor retained the right to use). All Corporation G can do is develop and commercialize licensed products in the Territory B, and enforce some of the patents that allow that right to be exclusive as to third parties. The Agreement A remained in effect, as modified, with none of the modifications changing the language providing that each party continues to own its own patents.

Pursuant to the clear terms of the Agreement B, Corporation A retained significant controls: it still had the authority to review Corporation G's marketing plans, Corporation A continued to participate in meetings It continued to use the patents and know-how for its own research: research that culminated in patent applications that Corporation A continued to file, See Walen v. United States, 273 F. 2d 599, 602 (1st Cir. 1959) (subsequent grant of a license, even though the license turned out to be unproductive, supported its interpretation of the document as a mere license, not a sale of the patent).

Moreover, the documents Corporation A executed subsequent to the Agreement B continued to represent that Corporation A licensed and sublicensed rights to Corporation F, *e.g.*, the Date 45, document wherein Corporation B, Corporation C and Corporation A agreed to terminate the Agreement H since "Corporation A had sub-licensed" to Corporation G. There are also the subsequent amendments to the Agreement C, *e.g.*, the Agreement O in Year 13 that asserts Corporation A sublicensed rights and obligations.

The fact that Corporation G now is the one that must pay for and protect its commercialization exclusivity by maintaining and prosecuting infringement of the licensed patents and can indulge infringement of the licensed patents that belong to Corporation A (subject to Corporation B's rights in the Agreement C and further subject to Corporation A's obligations imposed by the Agreement C) does not evidence a sale of the patents and know-how given that Corporation A could not sell Corporation B's property and did not add any language selling its own patents and know-how. All that these terms indicate, given the unambiguous, plain and clear license language in the documents taken as a whole, is that Corporation G must now pay the cost of protecting its commercialization exclusivity in the Territory B from third parties. The Agreement B, by its very terms, carefully kept ownership of Corporation A's and Corporation B's intellectual property with Corporation A and Corporation B, respectively. In light of the plain and unambiguous language of the document indicating a license and the facts, Corporation A's Agreement B cannot be treated as selling patents or know-how.

Section B, Factor Six: Corporation A Retained Substantial Rights that Precludes Treating the Agreement B as a Sale for Tax Purposes

In the context of the body of law that looks to the intent of the parties, what the transferor owned, the applicable tax doctrines, and the agreements, the Waterman rule is applied to determine if the transaction can have the legal effect of a sale pursuant to patent law. Waterman and the cases applying the Waterman Rule have established that the retention of certain rights *per se* precludes assignment (sale) treatment. These *per se* substantial rights include:

- Right to sue for infringement. Transfer of this right was specifically required by Waterman (138 U.S. 252 at 255). See also Sicom Systems, Ltd. v. Agilent Technologies, Inc., 427 F.3d 971, 979 (Fed. Cir. 2005) ("[A]n important substantial right is the exclusive right to sue for patent infringement. This right is substantial because the right to sue is the means by which the patentee exercises "the right to exclude others from making, using, and selling the claimed invention.") 427 F.3d at 979 (citations omitted).

- Right to indulge infringement. In Grantham v. McGraw-Edison Co., 444 F.2d 210 (7th Cir. 1971), reh'g denied,[23] the court found the retention of the right to sue for infringement in an agreement transferring an interest in a patent to the petitioner was not an impermissible division of the patent; rather, it was a withholding of the right to indulge infringement, a substantial right that made the agreement a mere license.

- Any of the three required rights, *i.e*., the rights to make, use and sell. In Cleveland Graphite Bronze Co. v. Commissioner, 10 T.C. 974, 989 (1948), aff'd 177 F.2d 200 (6th Cir. 1949), after stating that the transaction document must be unambiguous and show a clear intent to part with the patent and holding that related documents must be construed together, held the transaction was a license because only the rights to produce and sell were granted, not the three rights required by the Waterman Rule.

- Transferor making, using and/or selling. Waterman required that the transfer of these rights be exclusive, even as to the patentee/transferor. 138 U.S. at 256, 260.

- Transfer for less than the term of the patent or for less than perpetuity if know-how. Aspex Eyewear, Inc. v. Miracle Optics, Inc., 434 F.3d 1336, 1342-43 (Fed. Cir. 2006) ("By having rights for only a limited portion of the patent term, it simply did not own the patent. It was merely an exclusive licensee without all substantial rights"). Pickren v. United States, 378 F.2d

[23] Attached to, and made a part of, the opinion in Grantham was a *per curiam* opinion on the denial of rehearing, addressing the *sub nom* reversal of one of the cases cited by the Seventh Circuit for another issue.

595 (5th Cir. 1967) (transfer of secret formula for 25 years was not a sale because know-how was not transferred in perpetuity).

Many other cases support that these are substantial rights that cannot be retained if sale treatment is sought. For example, in the patent case of Abbott Laboratories v. Diamedix Corporation, 47 F.3d 1128 (Fed. Cir. 1995), Abbott objected to Diamedix intervening on the grounds Abbott's agreement with Diamedix assigned the patent to Abbott. The Court agreed that Abbott obtained broad rights; but, the fact that (a) Diamedex retained the right to make and use for its own benefit; (b) the patent was subject to prior licenses; and (c) Abbott did not enjoy the right to indulge infringement although it could initiate a suit against an infringer, precluded the agreement from being an assignment. In so holding, the Court relied on Waterman and its progeny.

An entire body of law has developed relative to whether the quantum of rights retained precluded a sale. For example, retaining, as a whole, too much control, precludes the transaction from being treated as a sale transferring the rights to make, use and sell. See Allied Chemical v. United States, 370 F.2d 697, 700 (2nd Cir. 1967) ("[T]he aggregate rights and controls retained by Allied, together with their own contemporaneous statements convince us that Allied neither intended nor effectuated a sale. . . . ") and Oak Manufacturing Co. v. United States, 301 F. 2d 259 (7th Cir. 1962). In Oak Manufacturing the court held, based on the terms of the agreement, that the patents were not assigned; rather, the agreement was in the nature of a franchise for the distribution of products. Cf. Schmitt v. Commissioner, 271 F. 2d 301, 307 (9th Cir. 1959),[24] aff'g, 30 T.C. 322, acq. 1958-2 C.B. 7 (In finding the 11 substantially similar agreements in different territorial areas were not sales agreements, the court looked at the totality of the facts and stated "realistically considered, they more closely resemble a licensor's control of a licensee than an assignor's sale of 'all substantial' property rights.").

Corporation A retained *per se* rights. Corporation A retained the right to use its own patents and know-how, and Corporation B's patents and know-how, given it did not make the license and sublicense exclusive even as to itself in the Agreement B.[25] In

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[24] The years at issue were 1949, 1950, and 1951, with the Ninth Circuit opinion issued in 1959. After the years at issue, but before the case was decided, in 1956 Congress retroactively amended the 1939 Code by the addition of I.R.C. § 117(q) to make § 1235 of the 1954 Code retroactive to 1950. S. Rep No. 84-1941 *as reprinted in* 1956 U.S.C.C.A.N. 2914. The Ninth Circuit, in the Schmitt opinion, noted that, technically, the same statute did not apply to all three years and that §117(q) was enacted in 1956 to make § 1235 retroactive to 1950. 271 F. 2d at 303, n. 4 and 5. Thus, for the 1949 year this was not a § 1235 case.

[25] One of the reasons neither document may have been exclusive as to Corporation A is that Corporation A would not have been able to fulfill its non-delegable obligations in the Agreement C if it did not retain both the rights in the Agreement C and rights to use its own patents and know-how, thus Corporation A did not give up those rights in order to retain the benefits of the Agreement C.

addition, the Agreement B is still subject to the Agreement C, a license that did not grant or allow either Corporation A or Corporation G the right to make the Device A, withholding from both of them the unpatented know-how that could enable them to manufacture the Device A. Thus, neither Corporation A nor Corporation G was granted the three mandatory rights (make, use and sell) for the Device A. In addition, Corporation A retained many "strings" that included review of marketing, commercialization, and as well as the fact that Corporation A's obligations under the Agreement C were personal. See, for example, discussion of the Date 48 Agreement N in "Facts" section, above (Corporation B could require Corporation A to resume obligations that Corporation A was imposing on Corporation G). Realistically considered, the substance of the agreement matches the words; the property is licensed.

Corporation A also retained the rights to develop and commercialize for Use C. Corporation A bears the burden to establish the retention of this was not a substantial right in light of the facts and circumstances and to establish the retained field of use had no substantial value at the time of the transfer. When the Agreement B was executed, Corporation A had Amount 6 patent applications pending relative to the use of the Device A for Use C, with its Corporation A's burden cannot be carried by mere uncorroborated statements that there was no value or that Corporation A did not intend to take advantage of the retained rights. See Young v. Commissioner, 269 F. 2d 89, 93 (2nd Cir. 1959) (the transferor failed to carry its burden of proof to establish the retained rights are not substantial and had no value). Corporation A has not provided a valuation of the retained rights to develop and commercialize the Device A for Use C. Moreover, to the extent the Use C is a separate claim in any of the patent applications or patents, Corporation A cannot have sold the patents, as the discussion of Pope Manufacturing Co (144 U.S. 248) and Lucent Technologies (543 F. 3d 710 at 720), above, establishes.

To summarize some of the rights Corporation A retained after the Agreement B:

- All rights to develop and commercialize the Use C
- The rights to use all of the intellectual property (patents and know-how) the subject of the Agreement B, whether owned by Corporation A, Corporation B or Corporation G
- Review of Corporation G's marketing and
  Review of Corporation G's
- Every right retained in the Agreement A that was not specifically altered by the Agreement B

In addition, Corporation A cannot sell its own know-how and improvements subject to the pre-existing licenses it granted Corporation B in the Agreement C for the rest of the world, a grant that enabled Corporation A to retain the valuable rights in the Agreement C. For tax purposes, if the transferor retains substantial rights in patents via pre-existing licenses the transferor granted, there is retention of valuable rights in the patent that precludes sale treatment. The Commissioner does not agree with the 1967 case that held to the contrary, Bell Intercontinental Corp. v. United States, 381 F. 2d 1004 (1967), 1967 WL 16240 (IRS AOD August 23, 1967). Bell Intercontinental analyzed multiple agreements and is cited for many different propositions of law. One of the issues that Bell Intercontinental addressed was the issue of whether a patent could be sold subject to a pre-existing cross-license required of all airplane manufacturers in the Manufacturers Aircraft Association (MAA). The Commissioner's action on decision (AOD) addressed the government position that sale treatment was precluded because Bell retained substantial rights in the inventions, *i.e.*, the right to receive royalties under the cross-license. The AOD stated:

> The court, while recognizing that 'hard precedent is lacking' concluded that the fact the inventions were subject to the MAA cross-licensing agreement (which was described as a 'previously imposed limitation upon, not a reserved right to') did not defeat a sale. In addition, it held that the retention of the right to receive royalty payments did not constitute the reservation of a 'substantial right.' *We feel that regardless of whether the cross-licensing agreement is described as a 'previously imposed limitation' or as a 'retained right' the fact remains that, because of the MAA agreement, Bell could not and did not grant the 'exclusive' right to manufacture, use and sell the inventions. Support for this position is found, we believe, in First National Trust & Savings Bank of San Diego v. United States, 200 F. Supp. 274 (S.D. Cal. 1961).* [[26]] *Cf., Allied Chemical Corporation v. United States, 370 F.2d 697 (2d Cir. 1967).* However, there is no basis for a petition for a writ of certiorari since there is no conflict with any appellate court decisions and since we are unable to show administrative importance.

1967 WL 16240 (IRS AOD August 23, 1967) (emphasis added).

[26] First National Trust and Savings Bank of San Diego v. United States, 200 F. Supp. 274 (S. D. Cal. 1961) ("FNT&SB of San Diego"), is a § 1235 case, technically not determinative for C corporation transfers. However, the court's finding that transferring a patent while retaining the right to receive royalties from a pre-existing license constituted retention of a substantial right is informative. 200 F. Supp. at 281-282. The difference for C corporation transfers is that this analysis is not based on § 1235 regulations, but on the retention of rights. MacDonald v. Commissioner, 55 TC 840, 859 (1971), acq. 1973-2 C.B. 2, rejected FNT&SB of San Diego and followed Bell International. MacDonald failed to analyze the impact of patent law, with complex facts involving contractual rights and prior settlements impacting the opinion. MacDonald is cited for support in Rev. Rul. 78-328, 1978-2 C.B. 215, which ruled that the sale of a patent used in the taxpayer's manufacturing business was a sale within section 1231, when the patent was subject to a non-exclusive, royalty-free license granted by the initial transferor to the taxpayer (not the taxpayer). Subsequent decisions of the Tax Court that have relied, in part, upon the analysis in MacDonald, have been reversed upon appeal. Blake v. Commissioner, 615 F.2d 731 (6th Cir. 1980), aff'ing in part, rev'ing in part, and remanding, 67 T.C. 7 (1976); Eickmeyer v. Commissioner, 580 F.2d 395 (10th Cir. 1978), rev'ing, 66 T.C. 109 (1976).

In addition to the fact the that the Commissioner does not agree with Bell Intercontinental, 381 F.2d 1004, it is important to take into account that Bell Intercontinental reached its position by analogizing a patent transfer to the sale of real property subject to an easement. Such treatment is contrary to the Supreme Court cases, cited above, that indicate a patent cannot be treated in the same manner as other assets. Some of the cases cited in Bell Intercontinental, which allow a patent to be sold subject to a pre-existing license, do not actually support the Bell decision. For example, footnote 4 in Bell Intercontinental noted the point for which Rollman v. Commissioner, 244 F. 2d 634 (4th Cir. 1957), acq. 1956-1 C.B. 8, is relied upon was not litigated, and (while not addressed by Bell Intercontinental) the appellate opinion in Rollman states that the pre-existing licenses were with respect to a separate patent not owned by the taxpayer's whose payments were at issue (244 F. 2d at 641).[27] Rouverol v. Commissioner, 42 T.C. 186 (1964), non-acq. 1965-2 C.B. 7, another case cited by Bell Intercontinental, was non-acquiesced in by the Commissioner. Some of the other cited cases were already discussed above, such as Merck & Co. v. Smith, 261 F.2d 162 (3rd Cir. 1958). In addition, the Federal Circuit recently distinguished and limited Bell International in Prima Tek II, L.L.C. v. A-Roo Co., 222 F.3d 1372, 1379 (Fed. Cir. 2000).[28]

A more difficult question is whether, as a matter of patent law, transferring a patent subject to a pre-existing license (exclusive or non-exclusive;[29] with or without royalties) precludes treating the transaction as an assignment of the patent. See Abbott Laboratories, 47 F.3d 1128 at 1132 (addressing a transfer subject to a pre-existing license in the context of other retained rights). While there is a Third Circuit case that found an assignment was effected when one document assigned both the patent and the preexisting license (Hook v. Hook & Ackerman, 187 F.2d 52, 58 (3rd Cir. 1951) there is no Federal Circuit or United States Supreme Court case that resolves whether

[27] General Aniline & Film Corp. v. Commissioner, 139 F. 2d 759, 760 (2d Cir. 1944), also cited by Bell Intercontinental, is a tax withholding case wherein the court stated a "belief" that title passed with dicta commentary in a footnote speculating that at the time of the transfer a transferee could probably simultaneously grant a license back to the transferor, a separate issue not addressed in this memorandum.

[28] Prima Tek II, a Federal Circuit case decided in 2000, considered whether all substantial rights had been transferred in a patent in order to decide if the plaintiff had standing to sue for infringement. The court stated it must determine the intent of the parties and that "[i]n so doing, it is helpful to look at what rights were retained by the grantor." 222 F. 3d at 1378. The court found the agreement at issue did not transfer all substantial rights so the lead plaintiff lacked standing to bring the infringement suit without the patentee, and because all other plaintiff's derived their interests from the lead plaintiff they too lack standing stating "[t]his is because an owner or licensee of a patent cannot convey that which it does not possess." 222 F. 3d at 1382.

[29] An exclusive license is significantly different than a non-exclusive license, as discussed in an article addressing standing to sue for infringement and joining the patentee, William F. Lee, David B. Basset and Jeffery C. Morgan, "When an Exclusive License Is Not an Exclusive License: The Standing of "Exclusive" Patent Licensees to sue after Ortho Pharmaceutical Corp. v. Genetics Institute, Inc., 7 Fed. Cir. B.J. 1 (1997).

an assignment did or did not occur for a transaction when the only issue was a pre-existing license (be it exclusive or non-exclusive; royalty or non-royalty). Thus, for tax purposes, the position in the Bell Intercontinental AOD is applicable, *i.e.,* that, as a matter of fact, transfer of a patent subject to a pre-existing license granted by the transferor that retains rights of value to the transferor precludes the transfer from being treated as a sale for tax purposes.

Hooker Chemicals and Plastics Corporation v. United States, 591 F.2d 652 (Ct. Cl. 1979), a case that upheld sale treatment, is frequently misinterpreted. The facts of that case established that Hooker Chemicals and Plastics Corporation (Hooker), a domestic corporation, terminated its agreements with three unrelated foreign corporations for the use of Hooker's intellectual property in the European territories the subject of the agreements so the agreements could be re-drafted for capital gain treatment. The new agreements were ambiguous.[30] The court found, even though the new agreements could terminate prior to the expiration of the subject patents, the transferees were to own the foreign patents the subject of the agreements in their respective territories. The court stated relative to this finding that "[i]t is important to note in this connection that the Government does not contend that plaintiff failed to give up all its rights in the patents because of the 10-year termination provision. 591 F. 2d at 661.

In the new agreements, each transferee explicitly obtained the right to sue for infringement in their respective territories, with it "implicit" from the agreements that the transferees obtained the rights to assign and license the patents in their territories. A clause was inserted into each agreement so, in name, Hooker could import and export to the foreign territories merely to avoid any implication there could be a violation of anti-trust laws based on territorial divisions of the business; but, exercising those rights would not have been economically feasible due to the cost to ship the products due to their weight and export duties, with the import provision subsequently withdrawn from the agreement. The court found that Hooker intended to sell all right title and interest in its intellectual property the subject of the agreements, and did, stating:

> The cardinal rule in the interpretation of contracts is to ascertain the mutual intention of the parties and then give effect to that intention, *so long as it is consistent with legal principles.*

591 F.2d at 658.

In Hooker, the government argued (1) the retained import and export rights were valuable so the agreements were license agreements; (2) Hooker retained rights in the know-how; (3) Hooker held the patents and know-how for sale in ordinary course of

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[30] For example, with respect to the know-who court stated "Although there is a certain ambiguity in the language of the agreements on this point, if one reads the agreements in their entirety and focuses on some of the relevant factual circumstances surrounding this point, one must come to the conclusion that . . . license or sublicense was not what was intended by the parties. 591 F. 2d at 662.

business so they were not capital assets; and/or (4) a portion of the monies received were for services. On the first contention, the court rejected the government arguments, stating:

> The Government contends that plaintiff's reserved right to import its products into the geographic territories covered by the 1963 agreements was a substantial interest in the patent rights and defeats the sale status of the transaction. The Government apparently concedes that the right was exercised by Hooker in, at most, a *de minimis* manner, and only at the request of the transferees, but notes that the mere lack of use of a right does not diminish its potential value. *Although the Government is correct in its legal proposition, it has missed the point factually.*
>
> The facts indicate that the right to import was of no practical value to Hooker. The right permitted Hooker to manufacture the chemical products in the United States and to sell them in the geographic territories in Europe reserved exclusively for [the transferees]. Because most of the products were predominantly water-based, their shipping costs were relatively expensive. There was also a duty cost which had to be considered. Thus, while Hooker had the theoretical right to compete with [the transferees] in parts of Europe, in practice the right was of no significance. It was not commercially feasible for Hooker to compete with its transferees in Europe.

591 F. 2d at 658-59 (emphasis added) (citation omitted).

For the government's second contention in Hooker, the court found the know-how was so closely inter-twined with the patents that the treatment was the same. For the third contention, the court pointed out that the government had originally conceded Hooker was not in the business of selling its intellectual property domestically, and raised the claim Hooker was in the business of selling it in foreign countries on its post trial brief. The government had stipulated to the contrary, and the court found it was too late to request relief from its stipulation and raise the issue. For the fourth contention, the government lost its services argument because all services were merrily ancillary to the patent sale, with the services provided *de-minimis*. Thus, Hooker is a fact-based case that did not reject patent law and found no substantial or valuable rights were retained.

Regardless of whether Corporation A could sell its know-how subject to the license it previously granted Corporation B, Corporation A retained substantial rights in all of the patents and know-how the subject of the Agreement B.[31] Accordingly, the Agreement B cannot be treated as selling the intellectual property. At most, Corporation G obtained a

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[31] In addition, Corporation A failed to establish that it transferred its know-how in perpetuity, especially in light of the fact Corporation B's know-how reverts to Corporation B if the Agreement C terminates.

franchise to commercialize (excepting Use C) in the Territory B pursuant to which all receipts are still ordinary, as discussed below (Section C).

Section B, Part 7: Corporation A did not sell the Agreement C

If Corporation A contends it sold the Agreement C, it cannot prevail on that contention because a license of a patent cannot be sold without the consent of the patentee. See Unarco Industries, Inc. v. Kelley Co., 465 F.2d 1303, 1307 (7th Cir. 1972) (the monopoly authorized by the United States Constitution and conferred by federal statute and policy mandates that the question of whether a license can be assigned must be governed by federal law, holding a license cannot be assigned unless expressly agreed by the patentee).[32] PPG Industries, Inc. v. Guardian Industries Corp., 597 F.2d 1090, 1093 (6th Cir.), cert. denied, 444 U.S. 930 (1979) ("Questions with respect to the assignability of a patent license are controlled by federal law."). In re CFLC Inc., 89 F.3d 673 (9th Cir. 1996), the Ninth Circuit opined that

> [A]llowing states to allow free assignability of nonexclusive patent licenses would undermine the reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patents. . . . [The patentee] would lose the very important ability to control the identity of its licensees. ***
>
> Thus, federal law governs the assignability of patent licenses because of the conflict between federal patent policy and state laws. . . .

89 F. 3d at 679

Accordingly, since Corporation B did not consent to the sale of the Agreement C to Corporation G, tax law cannot treat the transfer as a sale of the license.[33] Moreover, even if Corporation B had consented to the sale of the Agreement C, if Corporation A retained valuable rights in the license (*e.g.*, continuing use of the intellectual property the subject of the Agreement C), it would preclude sale treatment.

Section C

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[32] In Unarco, Unarco sold a division of its business that held a license and the issue was whether sale of the division could effect a sale of the license without the patentee's permission. The lower court used state law to find a sale. In an opinion that analyzed constitutional and patent law, the Seventh Circuit found federal law preempts and a license cannot be assigned without the patentee's permission.

[33] Corporation B's consent to the Agreement A in the Agreement L between Corporation A and Corporation B, did not modify the fact that Corporation A's obligations in the Agreement C were personal as to Corporation A and did not consent to a sale.

If Corporation A did transfer any property under the Agreement B, the property transferred was a franchise under I.R.C. § 1253, pursuant to which contingent and certain non-contingent payments received are treated as ordinary income.

I.R.C. § 1253(a) provides that a "transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark or trade name." Section 1253(b)(1) defines "franchise" to include "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area."

Section 1253(c) provides that any amounts received by a transferor which are contingent upon the productivity, use, or disposition of a franchise are treated as amounts received or accrued from the sale or other disposition of property which is not a capital asset. Accordingly, if the item that is transferred is a "franchise," any payments to the transferor that are based upon sales by the transferee will receive ordinary income treatment. These contingent payments are treated as ordinary income even if the transferor has retained no significant power, right or other interest in the transferred franchise. In this case, if a franchise was transferred, then the net sale royalties and the supply royalties were contingent payments that would be treated as ordinary income pursuant to § 1253(c).

As to lump-sum or up-front payments received, however, a transferor will be required to treat said payments as ordinary income only if the transferor retained any significant power, right or continuing interest with respect to the subject matter of the franchise (§ 1253(a)) or to the interest transferred (i.e., the franchise) (§ 1253(b)(2)).[34] The ordinary income characterization is dictated by section 1253 regardless of whether the transfer was by license or by sale. Tomerlin Trust v. Commissioner, 87 T.C. 876, 886-887 (1986) (income from transfer of trademark was ordinary under section 1253, but was not royalty income giving rise to personal holding company tax liability because the transfer was by sale and not by license).[35] Therefore, if a franchise was transferred in

[34] There is a "literal distinction between the object of a significant retained right referred to in [§ 1253](a), and the object of the specifically described rights in [§ 1253](b)(2). Section 1253(a) refers to retained rights 'with respect to the *subject matter* of the franchise…..'.*** In contrast, section 1253(b)(2), which lists specifically defined rights, refers to rights retained 'with respect to the *interest* transferred'…. The 'interest transferred' can encompass less than the subject matter of a franchise…." Stokely USA , Inc. v. Commissioner, 100 T.C. 439, 450-451 (1993) (footnotes omitted). Further, the list of factors in subsection (b)(2) are not exclusive, and "significance" for purposes of applying subsection (a) is determined by looking at all of the facts and circumstances at the time of the transfer. Id., at 453, and 456-457.

[35] Whether the transfer was by sale or license remains relevant to resolving other tax issues such as, in this case, whether the transferor is entitled to recover its basis (if any) prior to recognizing income on the transaction. In other words, while § 1253 may determine the *character* of income received by the transferor, determining whether § 1253 applies will not resolve whether the transfer was by sale or license. Tomerlin Trust, Id., at 887-888.

this case, the $Amount 34 received by Corporation A in Year 13 will be characterized as ordinary income only if Corporation A retained “significant power, right or continuing interest” under either section 1253(a) or 1253(b)(2).

Section 1253(b)(2) identifies “significant power, right, or continuing interest” as including, but not limited to, the following rights with respect to the interest transferred:

> (A) A right to disapprove any assignment of such interest, or any part thereof.
>
> (B) A right to terminate at will.
>
> (C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.
>
> (D) A right to require that the transferee sell or advertise only products or services of the transferor.
>
> (E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.
>
> (F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

While the enumerated statutory list of “significant” items found at section 1253(b)(2) is not exhaustive, the listed items are deemed to be significant *as a matter of law*, so long as the term of the retained right is coextensive with the interest that is transferred. Stokely USA, Inc. v. Commissioner, 100 T.C. 439, 450-454 (1993).[36] Further, retained powers and rights not enumerated in section 1253(b)(2) may still be “significant” under section 1253(a), with the determination made based upon *all* the facts and circumstances at the time of transfer. Id., at 453. When testing the significance of retained powers and rights under section 1253(a), a retained power or right may be deemed significant even if it does not extend for the entire duration of the interest transferred. Id. at 456.

[36] In Stokely, the Tax Court found that the transferor’s ability to disapprove of transfers for a five-year period was not a significant power or right as a matter of law, under section 1253(b)(2)(A), because the power was not coextensive with the term of the trademarks that were transferred. However, a 20-year restriction barring use of the transferred trademark for pork and bean products was found to be a significant power retained by the transferor even though the 20-year period was not coextensive with the trademark term. After analyzing both the importance to the transferor of imposing said restriction and the effect of said restriction on the transferee’s business operations, the court determined that the restriction was “significant” for purposes of applying section 1253(a).

Section C, Part 1: Did Corporation G acquire a franchise under Agreement A?

The Agreement A gave Corporation G the right to distribute and sell any that is covered by the patents and know-how licensed, and sub-licensed, by Corporation A to Corporation G, as well as any Product Device A and was The commercialization provisions under the Agreement A fit neatly into the section 1253(b)(1) definition of "franchise" as a term which "*includes* an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." (emphasis added)

Courts have construed the definition of franchise broadly to include: the right to construct and operate cable television access within a specific geographical area (Tele-Communications, Inc. v. Commissioner, 95 T.C. 495 (1990), aff'd12 F.3d 1005 (10th Cir. 1993), acq. 1996-2 C.B. 1); the right to sell and distribute a computer program and to provide customizing and related technical support, (Syncsort Inc. v. United States, 31 Fed. Cl. 545 (1994)); as well as the more-traditional, McDonald's or Dairy Queen-type franchises. (Canterbury v. Commissioner, 99 T.C. 223 (1992) (operation of a McDonald's restaurant)). Courts have noted that Congress provided an "expansive definition" of franchise to "include" agreements to sell or distribute goods within a specified area, which does not exclude other things otherwise within the meaning of a franchise. See, e.g., Jefferson-Pilot Corp. v. Commissioner, 98 T.C. 435, 443 (1992), aff'd 995 F.2d 530 (4th Cir. 1993) (FCC licenses are agreements between the Federal Government and the licensee, under which the licensee agrees to provide the service of radio broadcasting within a specified area in exchange for the right to broadcast).

As one court noted,

> Franchise agreements that provide the franchisee with the right to distribute products or to provide services in a particular area typically transfer to the franchisee rights to other intangible assets that are used in conducting the franchised business. Often these rights involve trademarks, trade names, technology, trade secrets, or patents ….

Syncsort, 31 Fed. Cl. 545, 552 (1994).

> Viewing a "transfer of a franchise" as encompassing only the transfer of the intangible right to distribute products and provide services and not also as including the transfer of other unique intangible assets integral to the provision of such products and related services produces a fundamentally inaccurate picture of the business relationship created by a franchise transfer

Id. at 554.

In Syncsort, the taxpayer granted licensees the right to distribute a computer program, as well as the right to use trade secrets and technology to customize the programs for specific client use and to provide technical support to clients. The taxpayer argued that only the "naked right" to distribute the computer program was within the statutory definition of a franchise, and that the other assets transferred fell outside the scope of section 1253. The court disagreed, finding that all of the rights transferred were part of the business which constituted a franchise within the meaning of section 1253(b)(1).

The Agreement A clearly gave Corporation G a franchise within the meaning of section 1253. Further, the franchise encompassed all of the intangible rights included in the Agreement A (and the Agreement C) because the rights contained in said agreements were integral to the business of commercializing in the Country B, which was the franchised business. All of the rights and properties within the agreements are necessary to commercialize the Device A into profitable Products. In the Country B, Accordingly, the intangible assets necessary to (*i.e.*, access to, and permission to use, the Device A for know-how developed by Corporation B and Corporation A, *etc.*) are integrally connected to the commercialization and distribution of the franchised product. Further, the value obtained from commercializing the Products is significantly advanced if the Device A is under patent, while a patent on a Device A has little use standing alone if no commercialized product uses or is sold using the Device A. Accordingly, all of the intangible rights contained in the agreements are integrally related to conducting the franchised business (i.e., distribution and sales of Products Device A), so that all of the intangible rights are subsumed within the transferred franchise.

Section C, Part 2: Did Corporation A retain any significant power, right or continuing interest under the Agreement A?

To reiterate, under the Agreement A, Corporation G was required to pay Corporation A Payments B and Payments A, with sales-based royalties due .
Pursuant to section 1253(c), the sales-based royalties are ordinary income even without a determination that Corporation A retained significant power, rights or continuing interests under the Agreement A.

However, analysis of what Corporation A retained is relevant to determining whether the Payments B and Payments A are treated as ordinary income under section 1253.[37] To

[37] The Payment B made by Corporation G in Year 12 was $Amount 14, and a Payment A payment of $Amount 15 was made in Year 3, for the Use A. Corporation A reported both of these payments as ordinary income consistent with royalty income for a license.

have ordinary income treatment imposed under section 1253(a), Corporation A only needs to have retained <u>one</u> significant power. <u>Stokely</u>, 100 T.C. 439 at 450; <u>Tele-Communications, Inc.</u>, 95 T.C. 495 at 514-515.

There is no doubt that Corporation A retained significant powers and rights with respect to the 2006 interests transferred:

- Corporation A had the right to disapprove any assignment (§1253(b)(2)(A)). In addition, Corporation A had the right to prescribe the standards of quality of products used or sold, or of services furnished (*i.e.*,) and of the equipment used to promote such products or services (§1253(b)(2)(C)). For example, the Agreement A contained comprehensive requirements specifying the activities Corporation G had to conduct to commercialize the product in the first years from of the product, provided for Corporation A oversight of the efforts , and provided Corporation A with the option .

- Corporation A had the power to require Corporation G to purchase all of the Device A from Corporation A (§1253(b)(2)(E)). In <u>Jackson v. Commissioner</u>, 86 T.C. 492, 511-512 (1986), the requirement for Sublicensees to purchase their inventory from Sublicensor, which held the exclusive license to manufacture, distribute and sell the device, was found to be a significant retained power, right or continuing interest.

- Other than the $Amount 14 Payment B and the contingent Payments A, Corporation A was to receive net sales royalties (at a rate between Amounts 21 % and %) on all sales of the Product covered by the licensed patents or licensed know-how, or any Product Device A and which consideration would constitute a substantial element under the transfer agreement (§ 1253(b)(2)(F)).[38]

In addition, while Corporation A did not have the right to require Corporation G to sell *only* products or services of Corporation A, under the Agreement A Corporation A did

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[38] The statute does not provide any additional guidance as to what is required to determine that a payment is a "substantial element" under the agreement, and no regulations have been finalized interpreting section 1253. Proposed regulations, promulgated in 1971, provided that payments would be "substantial" if the contingent payments constituted more than 50 percent of the total estimated amount the transferee had agreed to pay the transferor. Sec. 1.1253-2(d)(6), Proposed Income Tax Regs., 36 Fed. Reg. 13148, 13151 (July 15, 1971). The proposed regulations were never adopted and were withdrawn on Apr. 27, 1993, 58 Fed. Reg. 25587, *corrected by* 59 Fed. Reg. 13470 (Mar. 22, 1994). Further, contingent payments totaling less than 50% have been found to be "substantial," with an analysis of all of the facts and circumstances required. <u>Nabisco Brands, Inc. v. Commissioner</u>, T.C. Memo. 1995-127 (contingent payments, to be made annually for ten years and forecasted to amount to approximately 25% of the total consideration of $53 million, were substantial).

prevent Corporation G from selling any products that were directly in competition with the Product. Finally, Corporation A, through
, also exercised power over Corporation G's operations.

While the sales and distribution rights and obligations were imposed on Corporation G, Corporation A retained the rights to develop the Device A, with the Agreement A giving Corporation G the right, and the obligation, to work jointly with Corporation A (at Corporation G's expense) to Device A for

The Agreement A provided that Corporation G was to comply with the Agreement M between Corporation A and Corporation B (Date 57), and was subject to inspection and audit of the manufacturing, testing, packaging and storage facilities by Corporation A and/or Corporation B.)

Accordingly, pursuant to § 1253(a), the $Amount 14 Payment B and $Amount 15
payment would be ordinary income.

Section C, Part 3: What is the character of the payments received, and to be received, by Corporation A pursuant to the Agreement B?

Following the Agreement B:

- Corporation A gave up its rights for all further development of any Products Device A in the Territory B, other than Use C. When the Agreement B was executed, Device A for Use A, while Corporation A and Corporation G for the Use B. After the Agreement B, Corporation G for Use B, as well as for any other Products that it could develop utilizing the Device A for any other than Use C. As the Corporation A's framed it, if Corporation G got for Use B, then Corporation A would lose out on that opportunity.[39]

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[39] Corporation A would not, however, completely "lose out on that opportunity" if the Product was for Use A in Date 35, since Corporation A was to receive royalties on the net sales of Product(s) from Corporation G during that Amount 2 year period. Since Corporation A and Corporation G had
, there was at least a possibility that the Product would be sold for Use B prior to the expiration of the Amount 2 year period for royalties. After the Amount 2 year period, Corporation A will receive as additional consideration under the terms of the Agreement B, a Amount 36 percent royalty measured by the price paid to Corporation B for the Device A (in addition to Corporation G reimbursing Corporation A what Corporation A paid to Corporation B for the Device A), with that Amount 36 percent of the price consideration increased by any increases in the Device A supplied to Corporation G.

- Corporation A would continue to make appropriate personnel having available for consultation with Corporation G. (Not only were such personnel available for consultation, but said personnel accompanied Corporation G to ,and continued to file and pursue patents, in Corporation A's name, after Date 54[40]).

- The was disbanded, and Corporation A gave up its option .[41] , Corporation A retained the right to review Corporation G's marketing efforts semi-annually.

- Corporation G was still prohibited from Country B Trademark A in order to improve sales of the other products which it marketed.

- Corporation A

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[40] Corporation A contends that said pursuit of patents was undertaken only at the direction, and for the benefit of, Corporation G. However, the patent applications remained in the name of Corporation A.

[41] It should be noted that, if it is argued that part of the fees paid under the Agreement B should be allocated to the Corporation A's relinquishment of its option . Consideration received for a covenant not to compete is treated as ordinary income when the amount received is found to be in lieu of the income that could be generated if the taxpayer did not refrain from the competition. Baker v Commissioner, 118 T.C. 452 (2002), aff'd 338 F.3d 789 (7th Cir. 2003) (insurance salesman had no property which could be sold so all amounts received were ordinary income, some of which consideration was also attributable to his agreement not to solicit customers for one year); Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979)(amount allocated to covenant not to compete is ordinary income); Beals' Estate v. Commissioner, 82 F. 2d 268 (2d Cir. 1936) (stock in the purchasing corporation given to the officers of selling corporation for their agreement not to compete was ordinary income to the officers); Kennedy v. Commissioner, T.C. Memo. 2010-206 (amount received by individual for consulting business was for services and for covenant not to compete, both of which require ordinary income treatment so no further allocation of consideration necessary); Horton v. Commissioner, 13 T.C. 143 (1949) (sale of accountant's business, capital as to goodwill and ordinary as to the covenant not to compete) acq. in result, 1959-2 C.B. 5. Since the income that would be generated if Corporation A , would be ordinary income, the consideration received for agreeing not to do so is also ordinary income. It is noted that Corporation G was relieved of its obligation to reimburse Corporation A for Corporation A's costs by Corporation A waiving its option .

- Corporation A gave up the right to enforce licensed patents and patents related to the Product or the Device A against third parties. However, Corporation A retained the obligation to defend the licensed patents and patents related to the Product or the Device A from claims of infringement brought by third parties.

- Corporation A remained obligated to perform under the Agreement C.

- Corporation G was still required to obtain the Device A from Corporation A, who was able to purchase the Device A under the Agreement C with Corporation B. On these Device A purchases, Corporation G pays a royalty to Corporation A in the amount of Amount 36 % of the Amount 45 % - Amount 46 % royalty payment which, pursuant to the Agreement C, Corporation A has to pay to Corporation B for the Device A. Corporation A and Corporation G were to create a working group to exchange information and coordinate payments to make sure Corporation G timely paid Corporation A, and Corporation A timely paid Corporation B, the patentee.

- As under the Agreement A, Corporation A was the initial primary manufacturer of Product, with a to Corporation G to occur when Corporation G's . For up to the first Amount 2 years, Corporation G would pay Corporation A only for its Cost of Goods in manufacturing the Product. Any manufacturing done by Corporation A after the initial Amount 2 year period, or undertaken after successful even if occurred during the first Amount 2 years, Corporation G would remit Corporation A's Cost of Goods, plus Amount 47 %. Corporation A continued to remain available as a .

- Corporation G still could not assign its interests under the Agreement A to a third-party without Corporation A's prior written consent, though the consent was not to be unreasonably withheld or delayed.

Even after the Agreement B, Corporation A continued to retain "significant power, right, or continuing interest" with respect to the subject matter of the franchise, and with respect to the franchise that was transferred.

As to the "subject matter" of the franchise, Corporation A retained the right to develop and commercialize in the Country B a Product the Device A for Use C. Further, Corporation A indicated that foreign equivalents of the Country B patent applications were filed when the Country B patent applications were filed because "patent rights are country-specific" and, according to Corporation A's , "Corporation A licensed Corporation G only its Country B patents. The foreign equivalents were not licensed. Therefore, Corporation A did not grant Corporation G any rights to such patented inventions outside of the licensed Territory B, *i.e.* the Country B." At the time the Agreement B was reached, Corporation

A was manufacturing the Product which was to be sold by Corporation G, and would remain the even after . Clearly, Corporation A retained continuing interests in the franchised subject matter.

Corporation A also continued to retain significant rights and powers in connection with the franchise sold or licensed to Corporation G. Corporation G was still required to purchase all Device A from Corporation A, and was then required to pay an additional royalty based upon those Device A purchases from Corporation A after the first Amount 2 years under the Agreement B. Corporation A still retained rights to review Corporation G's marketing efforts, and restrictions remained on Corporation G's ability . Corporation A continued to provide services in connection with for Use B and with securing Country B patents, in Corporation A's name, that it licensed to Corporation G. Finally, Corporation A could still bar assignment by Corporation G (although now it could not be "unreasonable" in doing so). Accordingly, the character of the income received by Corporation A, pursuant to the Agreement B, continues to be ordinary income under §§ 1253(a) and (b)(2).

Section D
Installment Method, Amount Realized, Basis, Interest and § 453A

I.R.C. § 453(b)(1) defines "installment sale" to mean a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Pursuant to § 453(j), installment sales include “contingent payment sales,” which are sales of property for which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs. Temp. Treas. Reg. § 15A.453-1(c)(1).

Pursuant to § 453(a), income from an “installment sale” is taken into account under the “installment method.” Section 453(c) defines "installment method" to mean “a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.” Section 453 (j)(2) directs the Secretary to prescribe regulations for an installment method that uses “ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.” Thus, “installment method” is not limited to transactions wherein income must be reported using a gross profit ratio. See Temp. Treas. Reg. §§ 15A.453-1(c)(2), 15A.453-1(c)(3) (regulations for transactions where the gross profit and/or the total contract price cannot be readily ascertained).

Pursuant to Temp.Treas. Reg. § 15A.453-1(c)(1), unless there is a timely election not to report a contingent payment sale of qualifying property on the installment method, such sale must be reported on the installment method. Temp. Treas. Reg. § 15.453-1(d)(3)(i) requires that the election be made in the manner prescribed by the appropriate forms for the taxpayer's return for the taxable year of the sale.

The Agreement B required at least one payment to be received after the close of the taxable year in which the Agreement B was signed, *e.g.*, royalties, among other payments. If Corporation A sold any property via the Agreement B, Corporation A sold property with payments due after the close of the year in which the sale occurred (*i.e.*, after Year 1). Accordingly, if the Agreement B could be treated as a sale of property, the sale would be an installment sale. Section 453(b)(1).

If the Agreement B were treated as effecting a sale of property, the aggregate sales price could not be determined by the close of Year 1 since the consideration included, *inter alia*, contingent payments (*e.g.*, royalties measured as a percentage of future sales, royalties measured as a percentage of the purchase price of the Device A and contingent Payments A) and the required reimbursement of all amounts that Corporation A is required to pay Corporation B pursuant to the terms of the Agreement C (some of these amounts were also contingent). The amounts that Corporation G will be required to pay Corporation A as reimbursements of Corporation A’s payments to Corporation B over the term of the agreement could not be determined as of the end of Year 1. The sales price would also include the value of the obligations of Corporation A that Corporation G assumed as part of the consideration for the agreement, as discussed further below. The obligations Corporation G will perform over the life of the agreement could not be quantified as of the end of Year 1. At the close of Year 1, the aggregate sales price could not be determined because it was dependent on contingencies and other unknowns. See Temp. Treas. Reg. § 15A.453-1(c)(defining contingent payment sale). Accordingly, if the Agreement B can be treated as effecting a sale of property, the sale is a contingent payment sale subject to §§ 453 and 453(j).

Therefore, since Corporation A is not a dealer in property and did not elect out of the installment method, it must report the payments it receives pursuant to the agreement, as amended in Year 1, under the installment method unless the transaction is otherwise disqualified (*e.g.*, the property sold – inventory, securities traded on established market, *etc.*— does not qualify for installment reporting). §§ 453 (a), (b) and (j). On its Year 1 tax return, Corporation A reported that it sold the Device A. Corporation A could not have sold the Device A that was owned by Corporation B. Moreover, Corporation A continued to use the Device A. On its Year 1 Form 6252, Installment Sale Income, Corporation A reported a gross profit percentage of Amount 40 percent. It reported installment sale income of $ for Year 1. On the Form 4797 filed as part of Corporation A's Year 1 income tax return, it characterized the income as " ." On the Form 4797, Corporation A indicated that the property sold was a license for the Device A, (not the Device A as it reported on the Form 6252). Irrespective of the specific property Corporation A reported to have sold, it did not report all of the consideration which would have been attributable to a sale.

Assuming for the sake of discussion that the Agreement B effected a sale of property, the sale would be a contingent payment installment sale subject to § 453 and Temp. Treas. Reg. § 15A.453-1(c). Each payment of principal received on a contingent payment installment sale must be allocated between taxable gain and return of basis, with the payments received during the year in excess of the basis allocated to such year reported as current income. The method of allocating basis to the years in which payments may be received depends on whether the contingent payment-sale is one for which (a) the maximum selling price is determinable, (b) the maximum selling price is not determinable but the time over which payment will be received is determinable, or (c) neither a maximum selling price nor a definite term is determinable. Temp. Treas. Reg. §§ 15A.453-1(c)(1),(2),(3) and (4).

In ascertaining if a sale has a determinable maximum price for purposes of applying the allocation in Temp. Treas. Reg. § 15A.453-1(c)(2), it is important to note the distinction between the definitions of contingent payment sale in Temp. Treas. Reg. § 15A.453-1(c)(1) (sale in which the aggregate selling price cannot be determined by the close of the year) and the definition of a contingent payment sale with a maximum selling price determinable in Temp. Treas. Reg. § 15A.453-1(c)(2)(i)(A) (maximum amount of sale proceeds that may be received can be determined as of the end of the year). An example of an agreement where the aggregate selling price cannot be determined, but the maximum proceeds can be determined, would be a sale agreement wherein the price is contingent on a percentage of profits so the aggregate selling price cannot be determined by the close of the year, but the agreement has a ceiling of $2 million dollars on the amount payable pursuant to the sale agreement. See Temp. Treas. Reg. § 15A.453-1(c)(2)(i)(B), Example (1).

Thus, for Corporation A's Agreement B to have a determinable maximum sales price, there would need to be some limitation on the consideration payable. Temp. Treas. Reg. § 15A.453-1(c)(2)(A). See Temp. Treas. Reg. §15A.453-1(c)(2)(B), examples (1) and (2) (both with a stated ceiling for all contingent and non-contingent payments). In this case, there is no ceiling. Without a stated ceiling, the stated maximum selling price will be determined, if possible, by assuming that all of the contingencies contemplated by the agreement are met in a manner that will maximize the selling price and accelerate payments to the earliest dates permitted under the agreement. Treas. Reg. § 15A.453-1(c)(2)(i).

In Corporation A's case, it is not possible to determine the maximum payable by assuming all contingencies occur since the amount of various obligations could not be quantified by assuming a contingency either would or would not occur by the end of Year 1. For example:

- the total sales of all during the first Amount 2 years of the agreement were not known as of the end of Year 1, so the amount of the royalties measured by a percentage of said sales were not determinable as of the end of Year 1;
- the amount of Device A to be purchased from the Amount 48 year of the Agreement B until the end of the agreement could not be known as of the end of Year 1, so the amount of the royalties measured by Amount 36 percent of the purchase price of the Device A were not determinable as of the end of Year 1
- the amount of reimbursements Corporation G would/will pay to Corporation A each year over the life of the agreement was not known as of the end of Year 1 since the amount of those reimbursements was dependent on the amounts Corporation A would/will pay Corporation B under the terms of the Agreement C. Consequently, the amount of reimbursements over the life of the Corporation A-Corporation G agreement were not determinable as of the end of Year 1; and
- the value of the obligations that Corporation G would/will perform on behalf of Corporation A over the life of the Corporation A-Corporation G agreement were not known as of the end of Year 1. The obligations were imposed on Corporation A under the terms of the Agreement C. As part of Corporation G's consideration for the Agreement B, Corporation A required Corporation G to perform the obligations on its behalf. The obligations Corporation G will be required to perform and the cost of performance could not be determined as of the end of Year 1.

Accordingly, the maximum sales price of a sale effected by the Agreement B was not determinable as of the end of Year 1.

In ascertaining if a sale has a fixed period so that the provisions of Temp. Treas. Reg. § 15A.453-1(c)(3) would apply to allocate the amounts received each year between gain and basis, the terms of the agreements are determinative. While Corporation A points out that Device A goes off patent in Year 16, neither the Agreement A nor the Agreement B terminate on the expiration of this patent; the Agreement A as amended by the Agreement B continues for an indefinite period, as long as there are sales of the licensed products or Device C using the Device A. Accordingly, Temp. Treas. Reg. § 15A.453-1(c)(3) does not apply.[42]

Accordingly, if the Agreement B is treated as effecting a sale of property,[43] the sale did not have a determinable maximum price or a fixed period. The sale would be reported as provided in Temp. Treas. Reg. § 15A.453-1(c)(4) addressing sale agreements with neither a stated maximum selling price nor a fixed period.[44] Temp. Reg. § 15a.453-1(c)(4) cautions that an agreement which neither specifies a maximum selling price nor a fixed period during which payments may be received raises a question of whether the payments received under the agreement are in the nature of royalty income from a mere license (as the Service asserts in Section B, above). If the Agreement B were to

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[42] But, if the Agreement B did have a fixed period, the basis in the property sold would be allocated ratably over the term of the agreement. See Temp. Treas. Reg. § 15A.453-1(c)(3)(ii) Example (1). The amount received each year in excess of the basis allocated to such year would be reported as income. If no payment is received or the amount of the payment received (exclusive of interest) is less than the amount of basis allocated to that year, the unrecovered basis is allocated to the next succeeding taxable year. No loss is allowed unless the taxable year is the final year of the agreement, or it is otherwise determined under the rules applicable to worthless debts that the obligation for future payments under the agreement has become worthless. Temp. Treas. Reg. § 15A.453-1(c)(3)(i). Although the sales-based royalty percentage specified in the documents at issue varies with the level of sales, basis would still be allocated ratably over the term of the agreement. The circumstances are distinguishable from those considered in Temp. Treas. Reg. § 15A.453-1(c)(3)(ii), Example (4).

[43] While it is the government's primary position that there has not been a sale of property, alternatively the government contends that **if** the Agreement B did sell any property, the only property that could have been sold was a franchise, with the character of the income received ordinary. See page 33, above (synopsis of position). See also Section C, above (if Corporation A did transfer any property under the Agreement B, the property transferred was a franchise under I.R.C. § 1253, pursuant to which contingent and certain non-contingent payments received are treated as ordinary income). Thus, prior to applying the installment sale provisions, it would be incumbent upon Corporation A to establish it did, indeed, sell a franchise (or, identify with particularity what other specific property Corporation A contends it sold and establish that, as a matter of fact and law, that specifically identified property was, indeed, sold). In addition, Corporation A would have to establish its basis, if any, in the franchise or the specifically identified property Corporation A contends it sold. The basis in the Agreement C, which was not sold, cannot be used as basis for any property that Corporation A contends it sold, as discussed below.

[44] Corporation A does not dispute § 1245 income/recovery must be separately reported as set forth in § 453(i), thus the required treatment of such income is not addressed herein.

be treated as selling property, the basis (if any) of the property sold would be ratably recovered over a period of 15 years commencing with the date of sale. [45] However, if the basis allocated to a year exceeds the payments received during the year, the excess basis is carried forward year to year until fully recovered or determined worthless. No loss is allowed prior to that time. Temp. Treas. Reg. § 15A.453-1(c)(4).

Corporation A, rather than correctly applying the installment method as provided in the contingent payment regulations, estimated the value of certain expected receipts for the first Amount 2 years as the full price. The use of estimates is not allowed by either Temp. Treas. Reg. §15A.453-1(c)(2) or Temp. Treas. Reg. §15A.453-1(c)(3). Corporation A erred in its application of the installment method by: (i) disregarding the fact that the agreement provides for consideration in addition to the Payment B payment and Amount 2 years of royalties measured as a percentage of sales; (ii) disregarding the fact the agreement does not have a term of Amount 2 years; and,(iii) use of the basis of property that was not sold (the Agreement C, as addressed in part 7 of Section B, above).

If Corporation A is attempting to vary the Agreement B by only treating the first Amount 2 years of payments as the consideration (rather than just erring in the application of § 453) Corporation A is precluded from varying the agreement.

Commissioner v. Danielson, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967),

See Spector v. Commissioner, 641 F. 2d 376 (5th Cir.), cert. denied 454 U.S. 868 (1981) (reversing the Tax Court decision that allowed an agreement cast as a non-sale to be treated as a sale for tax purposes without proof that, as between the parties to the agreement, there was mistake, fraud, undue influence or other factors sufficient to set aside the agreement of the parties, as required by the Danielson rule).

However, installment sale income does not include income from sales of personal property that is inventory as to the seller. § 453(b)(2). Thus, questions arise as to (1) whether the payments for the product Corporation A manufactured until Corporation G could take over the manufacturing are payments for inventory as to Corporation A and/or (2) whether the amounts paid to reimburse Corporation A for the cost of the Device A purchases from Corporation B are paid, in full or part, for inventory as to Corporation A. If the product manufactured or the Device A Corporation A sold to

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[45] Under Temp. Treas. Reg. § 15A.453-1(c)(7)(ii), alternative methods of basis recovery can be allowed if a taxpayer is able to demonstrate “prior to the due date of the return” that the application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. A taxpayer must submit a request for a private letter ruling in order to use an alternative method of basis recovery. Corporation A did not timely request alternative basis recovery; it is too late to submit a request for approval of an alternative method of basis recovery.

Corporation G are inventory as to Corporation A under the terms of the Agreement B, the sale of the Device A would not qualify for reporting under the installment method. The payments for the Device A would be reported as ordinary income from the sale of inventory.

To determine if Corporation A's sales of Device A to Corporation G represented sales of inventory, Corporation A's purpose in holding the Device A must be considered. Since entering into the agreements with Corporation G, Corporation A's purpose in manufacturing the products and in holding the Device A has always been the sale of the Device A, either directly or in products it manufactured for Corporation G prior to Date 59.

Corporation A asserts that the royalties that are to commence after Amount 2 years that will be measured as a percent of Device A purchases by Corporation G are paid for services, *e.g.*, serving as a backup manufacturer of the Product, rather than as part of the consideration for a sale of property. Corporation A's assertion is contrary to the plain language of the Agreement B. The Amount 36 percent royalty, measured by purchases of the Device A, is clearly stated to be a royalty in the Agreement B, part of the bargained for consideration for the Agreement B. Indeed, the reimbursement requirement in the Agreement B, § (quoted with emphasis in footnote 29, above), specifically references the royalty measured by Amount 36 percent of the purchases of Device A as the royalties to be paid after the royalties measured by sales are no longer payable, *i.e.*, after Amount 2 years. Corporation A is bound by the terms of the agreement it executed (Danielson, supra.) and cannot vary the terms by extrinsic evidence.

Section D, Re: Amount Realized

I.R.C. § 1001(b) provides the amount realized from a sale or other disposition shall be the sum of all money received plus the fair market value of any property received. Pursuant to the terms of the Agreement B, Corporation A will receive cash in the form of an Payment B, royalties measured by a percentage of sales for the first Amount 2 years after the execution of the Agreement B, royalties measured by a percentage of what Corporation A pays Corporation B for the Device A for the rest of the term of the agreement, and reimbursement of all amounts it pays to Corporation B under the Agreement C. Other than payments for property which is subject to treatment as inventory, this cash, albeit subject to contingencies that impact the amount and spread over time, is part of the amount realized from the Agreement B, assuming it is a sale agreement.

However, that cash is not the entire amount realized by Corporation A. The amount realized also includes the amount of economic benefit received by a taxpayer via the sale. Treas. Reg. § 1.1001-1(a). It includes such items as the amount of liabilities from which Corporation A was relieved, and any other benefits inuring to Corporation A as a result of the disposition. I.R.C. § 1001(b); Treas. Reg. § 1.1001-1(a) and § 1.1001-

2(a)(1). The amount realized from relief of liabilities is not limited to relief from debt instruments such as a mortgage, but includes relief from obligations such as Corporation A's obligation to fulfill the obligations imposed on it by the Agreement C. Thus, to the extent that there were additional obligations imposed on Corporation G in Year 1 (e.g., Corporation A's obligations under the Agreement C that were not already fully imposed on Corporation G by the Agreement A and/or there were requirements in Year 1 that Corporation G must fulfill), then the expense of complying with those obligations would constitute additional consideration received by Corporation A.

This conclusion is supported by Wright v. Commissioner, T.C. Memo. 1980-279, addressing a situation where the seller sold its property for cash and the agreement on the part of the buyer to satisfy certain work requirements. The court addressed the issue of whether the value to be accorded the buyer's agreement to satisfy taxpayer's work requirement was part of the amount realized. The court specifically stated, as follows:

> [W]e note that that case does not fall within the purview of the cancellation of indebtedness doctrine despite its superficial resemblance thereto. Cancellation of indebtedness issues arise in a two-party context where the debtor is able to satisfy his obligation to the creditor by paying an amount less than the face amount of the debt. See, for example, United States v. Kirby Lumber Co., 284 U.S. 1 (1931). By contrast we are here faced with a situation where a third person has for a consideration agreed to discharge an obligation of the petitioner. Conceptually, this case stands within the constructive receipt line of cases wherein the taxpayer whose obligation has been discharged is deemed to have received in-come in the amount of the obligation.

T.C. Memo. 1980-279, 1980 Tax Ct. Memo. LEXIS 305 at 14.

In accord, Fisher Companies, Inc. v Commissioner, 84 T.C. 1319, 1347-49 (1985), aff'd without published opinion, 806 F.2d 263 (9th Cir.1986), acq. in part and non-acq. in part, 1990-2 C.B. 1 (discharge of the taxpayer from its obligation to repair leasehold property sold was part of the amount realized). In Fisher, there was an assumption of the repair obligation; here there is no assumption equivalent to a novation, but that does not negate the concept that when a buyer is required to fulfill obligations of the seller, the value of the obligation that no longer has to be fulfilled is part of the amount realized.

Accordingly, Corporation A erred in applying § 453 by failing to include the value of the obligations imposed on Corporation A by the Agreement C, which are required to be fulfilled on Corporation A's behalf by Corporation G pursuant to this Agreement B, as part of the amount realized. For each year the Agreement B is in effect, the value of the obligations performed by Corporation G for

Corporation A, as imposed by the Agreement C, must be included in the amount realized that is reported each year. Thus, for the first year of the Agreement B, Year 1, the installment sale income is understated. The value of the work Corporation G performed for Corporation A (as required of Corporation A per the Agreement C) must be added to the amount includable in Year 1 under the proper application of the installment method if the Agreement B can be treated as effecting a sale of property..

Section D, Re: Basis

Corporation A contends that its basis in the property sold was equal to the capitalized amount of its Payments B and Payments A payments to Corporation B pursuant to the terms of the Agreement C, less the depreciation it claimed on such capitalized amount. However, given the fact that the Agreement C was not sold, the Payment B and Payment A paid for that license cannot represent the basis of the property Corporation A contends to have sold. I.R.C. §§ 1012 and 1016. Corporation A has failed to identify with specificity what it contends was sold. For any property Corporation A does subsequently identify with specificity as allegedly sold, assuming *arguendo* Corporation A can establish, as a matter of fact and law, the property could be and was sold, Corporation A will have to prove its basis in each such item of property. At this point, due to the failure to submit any proof regarding its basis for any property other than the retained Agreement C with Corporation B, there is no basis to reduce the amount realized and the entire amount received each year must be reported as income.[46] Corporation A erred in applying § 453 by failing to report the full consideration received each year as income from an installment sale.

Section D, Re: § 453 as Applied to a Transfer of a Franchise

If Corporation A transferred a franchise to commercialize license products in the Territory B, the income received would also be reported pursuant to the installment method. As established above, § 453(b) and the regulations thereunder provide, *inter alia*, that Corporation A's income from the sale of personal property (other than a kind which is subject to treatment as inventory) must be reported pursuant to the installment method of accounting. Since a franchise constitutes personal property, the proceeds must be reported under the installment method in accordance with I.R.C. § 453 and its attendant regulations. See Trivett v. Commissioner, 611 F.2d 655 (6th Cir. 1979) (Commissioner argued against the taxpayer's eligibility for installment sale treatment where the taxpayer had sold a Dairy Queen franchise, but did not contend that the franchise was not personal property). See also Rev. Rul. 55-374, 1955-1 C.B. 370 (sale of all taxpayer's rights to act as sole agent of a foreign manufacturer with respect to the sale and distribution of its products in the United States qualified as a sale of personalty and may be reported using the installment method). Thus, if the Agreement B is a

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[46] If Corporation A had a tax basis in the property purported to have been sold, the basis would be allocated ratably over 15 years.

franchise, the ordinary income must be reported pursuant to § 453 and the contingent sale regulations thereunder.[47]

Section D, Re: Interest[48]

In general, when property is sold on an installment basis and either no interest or an inadequate rate of interest is provided with respect to the deferred payments, I.R.C. § 483 treats a portion of the deferred payments as interest (and thus, ordinary income) for all tax purposes for both the buyer and the seller. Section 483(f) of the Code authorizes the Secretary to issue regulations applying § 483 to any contract for the sale or exchange of property under which the liability for, or the amount or due date of, a payment cannot be determined at the time of the sale or exchange. Section 1.483-4 of the regulations, which was issued under the authority of § 483(f), contains rules applying § 483 in the case of certain sales contracts that call for one or more "contingent payments." Accordingly, § 483 generally applies to contingent payment installment sales.[49]

Treas. Reg. § 1.483-4 establishes the treatment of contingent payments by reference to § 1.1275-4, which was issued simultaneously with § 1.483-4 and addresses the taxation of contingent payment debt instruments. Specifically, § 1.483-4(a) states that interest under the sales contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275-4(c). Consequently, all non-contingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in Treas. Reg. § 1.1275-4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in Treas. Reg. § 1.1275-4(c)(4). Thus, any contingent payment made is treated as a payment of principal in the amount of the present value of the payment, determined by discounting the payment at the test rate (as determined under Treas. Reg. § 1.1275-4(c)(4)(ii)(B)) from the date the payment is

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[47] The reasoning in TAM 7106301200A, 1971 WL 121845 (June 30, 1971) is in accord.

[48] I.R.C. § 1274 generally determines the issue price of a debt instrument issued in consideration for the sale or exchange of nonpublicly traded property. I.R.C. § 1274 is the principal interest imputation provision—that is, if I.R.C. § 1274 applies, then other interest-imputing sections, such as I.R.C. § 483, do not apply. See I.R.C. § 483(d). However, I.R.C. § 483, rather than I.R.C. § 1274, appears to apply in this case because the right to the deferred contingent payments would not be a debt instrument for federal tax purposes, a requirement for the application of I.R.C. § 1274 to a transaction. For example, see Example 2 of Treas. Reg. § 1.483-4(b). Accordingly, as here relevant, § 483 applies rather than § 1274. Note: For purposes of I.R.C. § 483 and § 1274, "property" does not include the right to use property. Treas. Reg. § 1,483-1(a)(1) and § 1.1274-1(a). Also, neither I.R.C. § 483 nor § 1274 applies to any amount that is conditioned upon the productivity, use or disposition of the property transferred in the case of any transfer described in I.R.C. § 1235(a) (relating to a sale or exchange of a patent). I.R.C. § 483(d)(4) and § 1274(c)(3)(E).

[49]The reasoning with respect to I.R.C. § 483 in TAM 199909003, 1999 WL 113074 (March 5, 1999) and TAM 9840001, 1998 WL 680158 (October 2, 1998) is in accord.

made to the date of sale; the remainder of the contingent payment is treated as a payment of interest. See Treas. Reg. § 1.483-4(a). Any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

Section D, Re: I.R.C. § 453A

After applying § 483, it is necessary to consider whether I.R.C. § 453A applies. Section 453A applies to any obligation which arises from the disposition of any property under the installment method but only if the sales price of the property exceeds $150,000. Installment obligations arising from an individual's sale of personal use property (within the meaning of § 1275(b)(3)) or of any property used or produced in the trade or business of farming (within the meaning of § 2032A(e)(4) or (5) are not subject to § 453A. .Section 453A(a)(1), which contains special rules for nondealers, provides that in the case of an installment obligation to which the section applies, interest shall be paid on the deferred tax liability with respect to such obligation in the manner provided under subsection (c). Section 453A(c)(1)provides that if an obligation to which this section applies is outstanding as of the close of any taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined in the manner provided under paragraph (2).

Section 453A(c)(3) provides that the deferred tax liability is the product of the amount of gain with respect to the installment obligation that has not been recognized as of the close of the taxable year multiplied by the maximum rate of tax in effect under either I.R.C. § 1 (individuals) or I.R.C. § 11 (corporations), as appropriate. Section 453A(c)(6) provides that the Secretary shall prescribe regulations as may be necessary to carry out the provisions of I.R.C. § 453A(c) including regulations providing for the application of this subsection in the case of contingent payments, short taxable years and pass-through entities. The Secretary has not yet proposed or promulgated such regulations.

Even without such regulations, contingent payment installment sales are subject to the deferred interest provisions of I.R.C. § 453A. See reasoning in FSA 199941001, 1999 WL 821656 (October 15, 1999) (applied figure used by taxpayer in calculating its gain on a contingent sale for the value of the property sold to calculate interest under I.R.C. § 453A); IRS NSAR 20080101F, 2008 WL 68731 (January 4, 2008) (the appropriate computation is to look back at the end of each year to compute the interest the taxpayer must pay); See also reasoning in TAM 9853002, 1998 WL 908368 (December 31, 1998) (taxpayer paid interest under I.R.C. § 453A, though the TAM did not analyze why he was required to do so). Thus, Corporation A's sale is subject to the interest charge imposed by §§ 453A and 453A(c).[50]

[50] This conclusion that contingent payments are subject to § 453A is bolstered by the language of § 453A(c)(6) itself, which provides that the Secretary shall prescribe such regulations as may be necessary to the application of this subsection in the case of contingent payments, short taxable years, and pass-thru entities. This clear language contemplates the payment of interest on tax deferred by the

In the absence of regulations under § 453A(c)(6), the Service allows taxpayers to use a reasonable method of calculating the deferred tax and interest on the deferred tax liability with respect to contingent payment installment obligations. Methods that may be used in calculating the deferred income (and thus the deferred tax) include (1) using the same methods used for determining the sale price outlined in Treas. Reg. § 15a.453-1(c)(2), or (2) simply using the amounts actually paid under the percentage-of-gross-sales/orders provision in the calculation of the deferred income (and thus the deferred tax). See reasoning in FSA 199941001, 1999 WL 821656 (October 15, 1999) (stating that in the absence of regulations under § 453A(b) defining "face amount" for contingent payment obligations, it is reasonable to look to the value of the transferred property (used in calculating the gain on the transaction) in order to ascertain a face amount of the installment obligation for purposes of § 453A(b)(2). However, to treat the face amount of the obligations as the estimated value of only the first Amount 2 years of the cash payments received (to be received) would not be reasonable since it is contrary to the terms of the sale.

Assuming the Agreement B effected a sale of property and Corporation A did not have any other installment obligations outstanding at the end of Year 1 that arose from installment sales during Year 1 the application of § 453A requires a means of allowing the taxpayer the benefit of the $5,000,000 threshold amount that is excepted from the interest charge. The language of the statute cannot be applied directly as contingent payment installment obligation(s) do not have a face amount. In order to avoid prejudicing the interests of the taxpayer, the first $5,000,000 of payments received after the year of sale is excepted from the application of § 453A(c). All payments received in the year(s) subsequent to the year of sale in excess of $5,000,000, in aggregate amount, are subject to the interest charge.

The deferred tax liability with respect to contingent payments received during the year is determined by multiplying the portion of the payments received that represents gain (the total amount of the payments received less any imputed interest and the amount of the basis in the property sold that is allocable to the taxable year) by the maximum rate of tax in effect under either I.R.C. § 1 (individuals) or I.R.C. § 11 (corporations), as appropriate. The deferred tax liability is then multiplied by the underpayment rate in effect under § 6621(a)(2) for the month with or within which the taxable year ends to obtain the amount of § 453A(c) interest due.

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use of the installment sale method. Failing to apply § 453A to contingent obligations would result in taxpayers who do not choose the installment method, who elect out of the installment method and are required to value and report contingent payments in the year of sale, paying more tax than taxpayers who use the installment method to defer their tax liability. Such disparate treatment is the very result that § 453A is designed to eliminate. See reasoning in TAM 9853002, 1998 WL 908368 (December 31, 1998) (by charging interest under I.R.C. § 453A, Congress required taxpayers who use the installment method to forgo the return (time value of money) that could be earned on the deferred taxes, thereby placing such taxpayers in a position similar to a taxpayer who elected out of the installment method).

After determining the amount of § 453A interest, interest on the § 453A interest is calculated for the period beginning on the due date of the taxpayer's return for the taxable year in which the sale occurred and ending on the due date for the taxpayer's return for the taxable year immediately preceding the taxable year in which a principal payment was received (the "interest period"). The amount of interest for the taxable year would be determined by multiplying the amount of the § 453A interest plus any accrued but unpaid interest from prior years by the underpayment rate in effect for the taxable year.

Section 453A(c) interest is prepaid for the year following the year for which a return is filed, e.g., the interest paid with a 2008 return compensates for the installment method's deferral of tax from the due date of the 2008 return (March 15, 2009 for a corporation or April 15, 2009 for an individual) to the due date of the 2009 return. Consequently, when determining § 453A(c) interest on the basis of the contingent installment payments received during a year, the deferred tax and interest on the deferred tax is determined as of the end of the prior year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The case relies primarily on the plain and unambiguous terms of the agreements; agreements that cannot be altered by extrinsic evidence. Thus, the fact that representatives of Corporation B and Corporation F, , have not been interviewed should not pose hazards.

Corporation A's "Response to Form 5701 for Corporation A Inc. and Subsidiaries regarding Device A " was received and reviewed prior to the issuance of this advice. Corporation A's response is insufficient in that, *inter alia*, it fails to establish that the Use C lacked value at the time the Agreement B was executed, ignores the language that addresses how to protect Corporation G's profits if Corporation A obtains for the Use C[51] and, for the

[51] The language for the is as follows:

closing agreement argument, disregards the Date 58, memorandum to Corporation A regarding “Deferral of Advance Payments” (including the discussion at pages ## asserting that "to qualify for deferral under Rev. Proc. 2004-34, the [Agreement A] agreement must be properly construed as a license and not a sale. . . * * * In addition, based on discussions with ...Corporation A . . . the intent was to license the patent and know-how to Corporation G, not to effectuate a sale of such rights."). For all the reasons stated in this advice, the Agreement B still did not effect a sale of any property, as asserted in the government's primary position. Alternatively, if any property was sold, the only possible property that could have been sold was a franchise, with the income therefrom ordinary whether or not Corporation A retained the Use C. Accordingly, the response does not pose significant hazards for the government's position.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (412) 395-4733 if you have any further questions.

(Large Business & International)

By: ______________________________

(Large Business & International)

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Large Business & International Division

Attachments (2)

Exhibit A
TIME LINE

Exhibit B