DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

Number: **200006024** November 5, 1999
Release Date: 2/11/2000
CC:DOM:FS:CORP
TL-N-7379-98

UILC: 1441.00-00
1235.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: Sale or License of a Patent

This Field Service Advice responds to your memorandum dated August 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Sub 1	=
Parent Corporation	=
Entity B	=
Entity C	=
Country B Government	=
Country B	=
Country D	=
Geographic Area V	=

Geographic Area X	=
Patent	=
Date B	=
Date C	=
Date E	=
Date F	=
Year B	=
Year C	=
Year D	=
Period B	=
Amount C	=
Amount D	=
Amount E	=
Agreement B	=
Agreement C	=
Agreement D	=
Agreement E	=
Clause B	=
Clause C	=
Clause F	=
B%	=
C%	=
Service Provider	=

ISSUES

Whether there was a sale or license of intangible property acquired by Sub 1 in Year B from its parent corporation, (hereinafter “Parent Corporation”).

CONCLUSIONS

Based upon the facts as we know them to be, we conclude that there was a license of the Patent because Parent Corporation did not transfer substantially all of its rights in the Patent to Sub 1.

FACTS

The Patent at issue in this case was initially developed by the Entity B and the Country B Government.

Agreement B- On Date B, Entity B and the Country B Government executed Agreement B with Entity C, where at Clause B:

> Entity B and the Country B Government hereby grant to Entity C the exclusive right and authority and license to the know-how and licensed patents to manufacture Patent in Country B and subject to Clause C outside Country B and to use and sell Patent in all countries of the world.

Clause C of Agreement B states that Entity C shall not have the right to manufacture the Patent outside Country B without prior written consent of the Country B Government.

Agreement B provided that subsequent developments made by Entity B or the Country B Government would be included within the scope of the license. In consideration for the license, Entity C agreed to pay royalties to Entity B and the Country B Government equal to C% of the royalty base (roughly net sales price to unrelated third-parties) for the Amount C units sold and thereafter B% on each unit sold.

Agreement C- On Date C, Agreement C was executed by Entity B, the Country B Government, Entity C, and Parent Corporation. This agreement substituted Parent Corporation for Entity C as licensee under Agreement B.

Agreement D- On Date E, Agreement D was executed by Parent Corporation, Entity B, the Country B Government, and Parent Corporation's subsidiary, Sub 1, wherein certain rights were assigned by Parent Corporation to Sub 1. Agreement D was effective as of Date F. Clause F of Agreement D states that the rights in Agreement B, as well as additional rights to the Patent intellectual property owned by Parent Corporation as of the date of the assignment, were transferred to Sub 1 to the extent that these rights relate to the use and sale of the Patent in Geographic Area X and, for the purposes of such use and sale in Geographic Area X, the right to manufacture the Patent in Country B and (subject to the Country B Government's

consent) in Geographic Area X. Agreement D did not assign to Sub 1 property rights relating to future developments. In consideration for the assignment of rights, Sub 1 agreed to pay the fair market value of the rights as calculated by Service Provider (Amount D). Sub 1 borrowed Amount D from Parent Corporation and repaid the loan by Year C. Sub 1 amortized Amount D over Period B based on the remaining life of the assigned patents, reducing gross income by Amount E in each year.

Agreement E- Due to Parent Corporation's inability to obtain approval from Entity B and the Country B Government to manufacture the Patent outside of Country B, Agreement E was executed by the same parties on the same day with the same effective date. In Agreement E, Parent Corporation acknowledged Sub 1's ownership of the Patent rights as they relate to the use and sale of the Patent in Geographic Area X and for the purposes of such use and sale the right to manufacture the Patent in Country B and (subject to Country B's previous consent in writing pursuant to Clause C of Agreement B) in Geographic Area X.

Agreement E granted Parent Corporation the right to manufacture the Patent in Country B for use and sale by Sub 1 in Geographic Area X. Parent Corporation did not pay any consideration for the right to manufacture the Patent in Country B for use and sale in Geographic Area X.

Most of the product development was performed by Parent Corporation. A small portion of research and development is conducted and paid for by Sub 1. Parent Corporation did not receive payments from its subsidiaries for the R&D expenses incurred. Most patents registered since Year B, including those for the United States and other countries, are registered in Parent Corporation's name. Only one patent developed since Year B is registered in Sub 1's name. All manufacturing operations are performed by Parent Corporation in Country B. The Patent is then distributed world-wide through Parent Corporation subsidiaries located in the United States, Geographic Area V, and Country D.

LAW AND ANALYSIS

Whether all substantial rights to the Patent are considered on a geographic United States or worldwide basis, the conclusion is the same.

The right conferred by a patent is with respect to excluding others from making, using and selling an invention throughout the United States. See 35 United States Code section 154. A transfer of a patent that fails to confer a right with respect to excluding others from either manufacturing, using or selling a patent within the United States results in a license, versus a sale, of a patent. Where a transferor, in this case Parent Corporation, does not transfer to Sub 1, a corporation controlled by Parent Corporation, all of the substantial rights to a patent within the United

States, the transfer of the rights to the patent cannot be a sale. Whether all of the substantial rights to a patent have been transferred is a question of facts and circumstances. The measure of ascertaining what has or has not been transferred is to examine what rights have been retained by the grantor. See Norgren Co., v. Commissioner, 268 F. Supp. 816, 819-20 (D. Colo. 1967). According to Agreement E executed between Parent Corporation and Sub 1 with respect to Sub 1's use and sale in Geographic Area X, Parent Corporation received the right to manufacture the Patent in Country B. As Agreement D and Agreement E were executed on the same day and were contrived by related parties, the transactions had the effect of the Country B Government granting permission to Parent Corporation to manufacture the Patent with regard to the use and sale of the Patent in Geographic Area X, and then Parent Corporation transferring to Sub 1 the right to use and sell the Patent in Geographic Area X (but Parent Corporation retained the rights for manufacturing the Patent with respect to Geographic Area X). Parent Corporation retained manufacturing rights to the Patent and therefore did not transfer all of the substantial rights.[1] See Buckley v. Commissioner, 57-1 USTC ¶ 9525 (D.C. Wash. 1957).

Also, we point out that at no time did the Country B Government and Entity B permit manufacture of the Patent outside of Country B. Sub 1 never was positioned to receive the right to manufacture the Patent in the United States, much less anywhere else other than Country B, because no such right was granted by the terms in any of the agreements. Substantial rights were not transferred to Sub 1 as the right to manufacture was not granted on a worldwide basis. As such, failure to convey the right to manufacture, use and sell the Patent on a worldwide basis resulted in a license and not a sale.

Failure to transfer all of the substantial rights with respect to the Patent results in foreign withholding taxes.[2] See Commissioner v. Wodehouse, 337 U.S. 369

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[1]We also note that the terms in Agreement D did not include intellectual property "subsequent development" language similar to that included in Agreement B. Retaining rights to future development is a substantial right withheld with respect to this product. See Norgren, at 819-20.

[2]We note that I.R.C. section 1235 does not apply to the case before us. I.R.C. section 1235 and the regulations promulgated thereunder were the result of an effort by Congress in the Internal Revenue Code of 1954 to provide for capital gains treatment, as opposed to ordinary income treatment, with respect to sales or exchanges of patents by individual inventors. Congress believed capital gains treatment would encourage individual inventors to create patents. I.R.C. section 1235 allows capital gains treatment where they might otherwise be disallowed under the Internal Revenue Code. I.R.C. section 1235 and the regulations promulgated thereunder provide that this

(1949) (a British author was paid lump sum amounts by U.S. publishers for the serial rights to his various works. The issue was whether those amounts were "rentals or royalties for the use of or for the privilege of using such copyrights and other like property in the United States, so as to be includible in the author's U.S. income. The author argued that such amounts were proceeds from the sale of his works, and therefore not includible. The Supreme Court found that the payments were for the privilege of using Wodehouse's copyrighted material in the United States, and therefore were royalties includible in his U.S. gross income).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

special provision is available only to individuals, not corporations or related persons, as defined in I.R.C. section 267(b). I.R.C. section 1235, and the regulations promulgated thereunder, are inapplicable with respect to this transaction because the transferor, Parent Corporation, is both a related person, with respect to Sub 1, and a corporation.

[redacted]

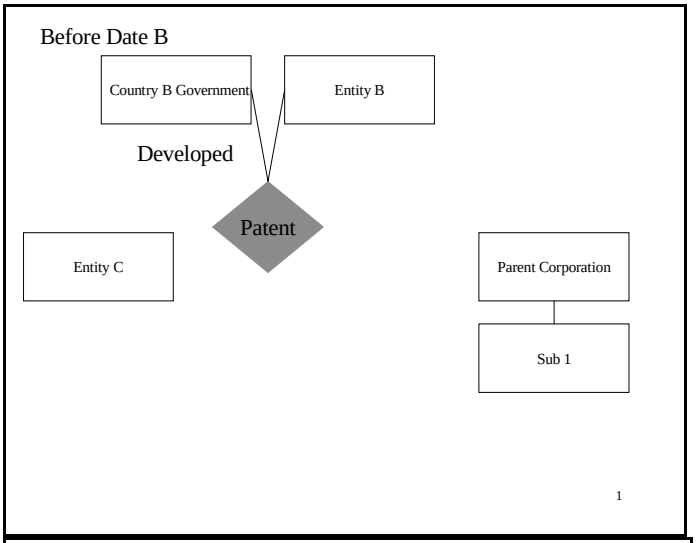
Please call us at (202) 622-7930 if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel

By: _____
ARTURO ESTRADA
Acting Branch Chief
CC:DOM:FS:CORP

Attachment (1) Seven Page Powerpoint Diagram of the Facts

Slide 1



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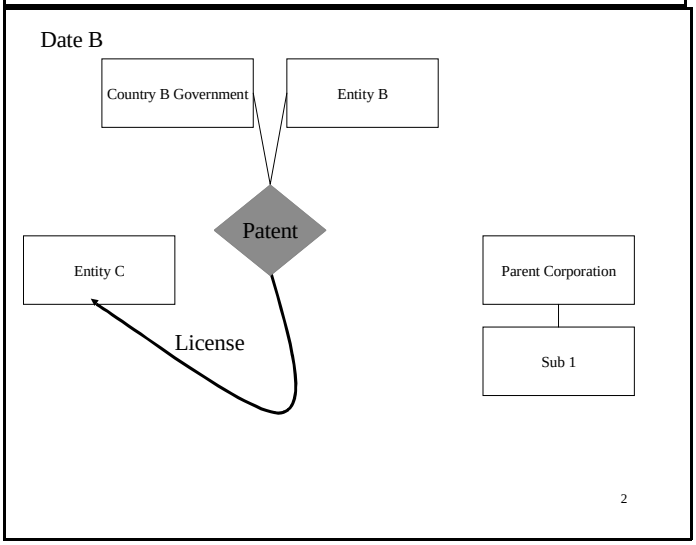

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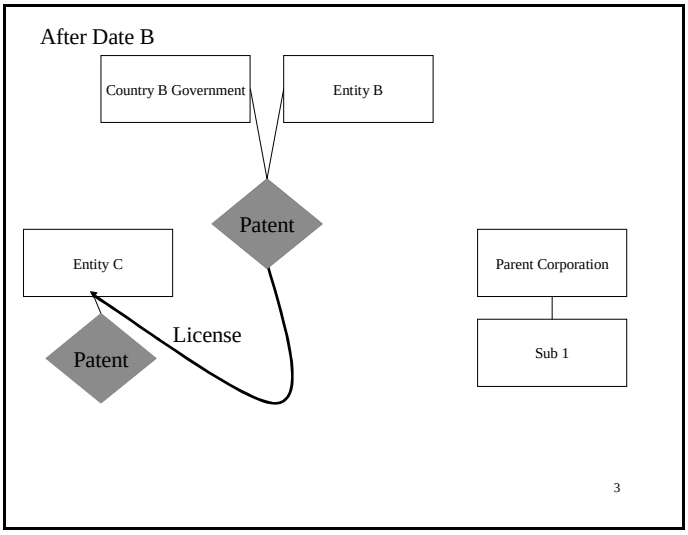

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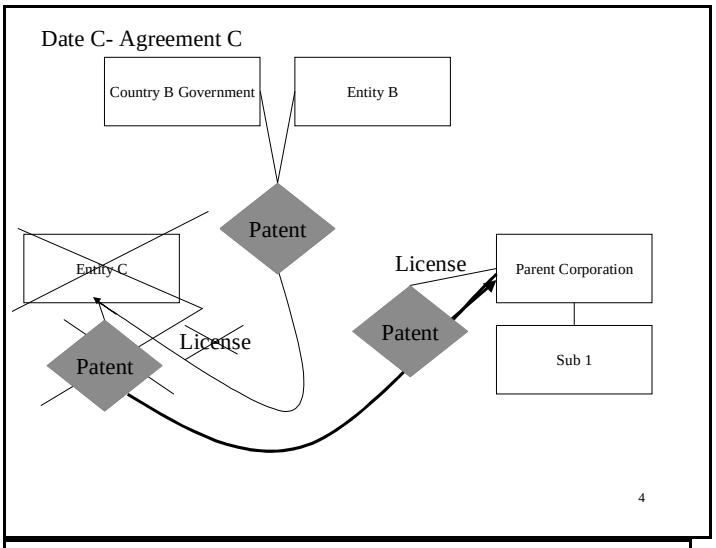

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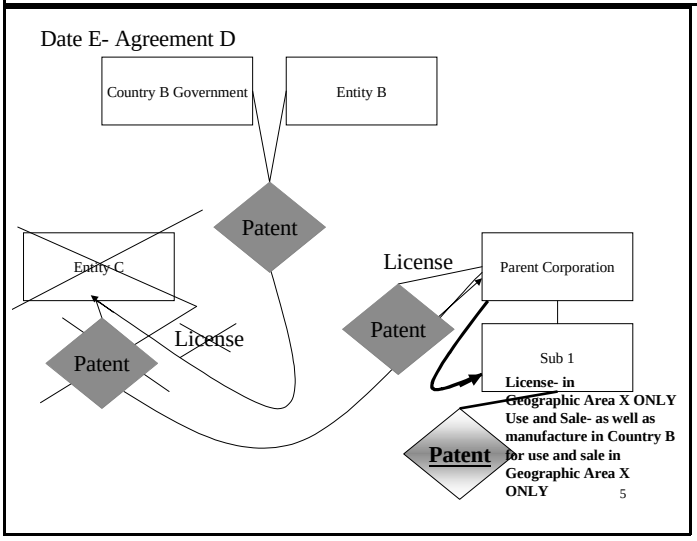

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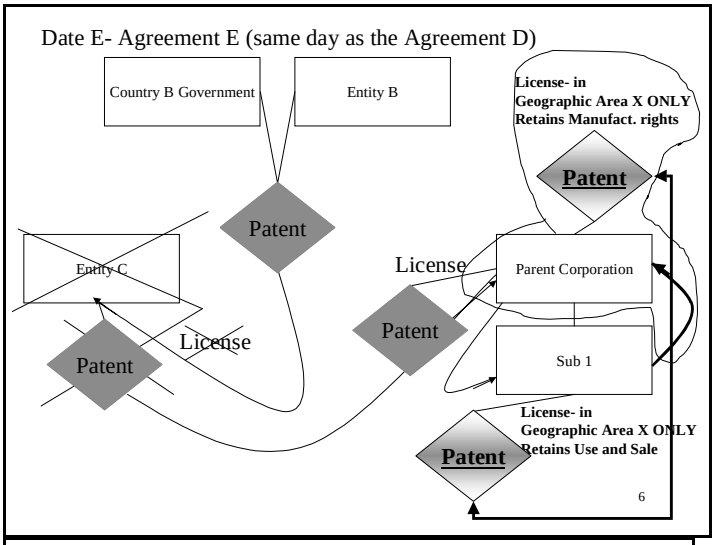

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