Internal Revenue Service

Department of the Treasury

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LEGEND

a =

A =

B =

C =

D =

E =

F =

Trust =

b =

c =

Corporation 1 =

X =

d =

State =

Y =

e =

Corporation 2 =

f =

Dear Sir or Madam:

We received your letter, dated September 19, 2000, requesting a ruling under § 1235 of the Internal Revenue Code. This letter responds to your request.

The information submitted and the representations made are summarized as follows: On a, A, B, C, D, E and F (individually, Grantor; collectively, Grantors) formed the Trust. A and B are co-trustees of the Trust.

Each grantor transferred to the Trust, without consideration, all his or its interest in certain patent applications, which have been, or will be, filed with the United States Patent Office. The various patents complement each other.

The Trust has b subtrusts. Each subtrust contains the patents, or interests in patents, assigned to the Trust by the Grantor who is the beneficiary of the subtrust. The trustee is required to distribute to each Grantor all of the net income (i.e. royalties minus administration expenses) of the respective Grantor's subtrust within c days after receipt of payments from the licensee.

The Trust Agreement provides that the purpose of the Trust (including the subtrusts) is to control the exploitation of the patents, and, after administration expenses and other required payments as set forth in the Trust Agreement, to distribute the royalties received from licensing the patents. The Trust is only to enter into exclusive license agreements that conform to § 1.1235-2(b)(2)(i) of the Income Tax Regulations to ensure that the royalties received by the Trust, which are allocable to individual Grantors, qualify for capital gain treatment under § 1235 of the Internal Revenue Code.

Section 1.4 of the Trust Agreement provides that only the Grantors may contribute additional assets to the Trust which assets, when contributed, shall be added to the respective contributing Grantor's subtrust.

Section 1.5 of the Trust Agreement provides that E, A, and others are entering into a Loan Agreement, dated a, which sets forth certain financial obligations of E to A and Corporation 1 (" E Obligations"). Until such time as all of the E Obligations are paid in full, E shall not be a Trustee of the Trust and shall only have a vote on X matters as one of the b Grantors who will decide all matters by a vote of a majority in number.

Section 1.7 of the Trust Agreement provides generally that the Trust is irrevocable and shall not be altered, amended or revoked by any person and, except on final termination or dissolution of the Trust, no part of the assets of the Trust shall revert to any Grantor at any time or under any circumstances. The Trust may be altered, amended or revoked only by a vote as set forth in Section 1.5 of the Trust Agreement, provided that any alteration or amendment which diminishes a Grantor's rights as a Beneficiary in the Trust must be approved in writing in advance by such Grantor/Beneficiary.

Section 2.5 of the Trust Agreement provides that on termination and liquidation of the Trust, the intellectual property assigned to the Trust by E shall be distributed to E, and the Grantors of Subtrusts No. d - b shall receive their interests in the intellectual property they contributed to the Trust.

Section 4.4 of the Trust Agreement provides that the Trust has been accepted by the Trustee in State and shall be construed under the laws of State. The Federal and State Courts having jurisdiction in the County of Y, shall be the appropriate venue for any and all actions or disputes arising out of or in connection with the interpretation or enforcement of the Trust Agreement.

In e, A and B began contract negotiations with Corporation 2. On f, A and B, entered into an agreement with Corporation 2. The agreement included an exclusive license to make, use, and sell the inventions for royalties set forth in the agreement. The allocation of relative values to the various patents was the result of arm's length negotiations between the Grantors themselves and between Corporation 2 and the trustees, on behalf of the Grantors.

You have requested a ruling that royalties received by each Grantors who is an individual from the exclusive license with Corporation 2 to make, use, and sell the patents the Grantor transferred to the Trust will be treated by the Grantor individually as capital gain under § 1235.

Section 301.7701-1(a) of the Procedure and Administration Regulations provides that the Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-1(b) provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Internal Revenue Code (such as § 860A addressing Real Estate Mortgage Investment Conduits (REMICs)) provides for special treatment of that organization.

Section 301.7701-2(a) provides that for purposes of § 301.7701-2 and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. Section 301.7701-3(b)(1) provides that except as provided in § 301.7701-3(b)(3), unless the entity elects otherwise, a domestic eligible entity is (A) a partnership if it has two or more members; or (B) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-4(a) provides that in general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules provided in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section1235(a) provides that a transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the

sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of the transfer are—

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on productivity, use, or disposition of the property transferred.

Section 1235 (b)(1) provides that for purposes of § 1235, the term "holder" means any individual whose efforts created the property.

Section 1.1235-2(d)(1)(i) of the Income Tax Regulations provides that the term "holder" means any individual whose efforts created the patent property and who would qualify as the "original and first" inventor, or joint inventor, within the meaning of title 35 of the United States Code.

Section 1.1235-2(d)(2) provides that although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership. For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than 1 year.

Based on the information submitted and the representations made, we conclude that the Trust is not a trust under § 301.7701-4(a) because its primary purpose is not protecting and preserving the trust property for beneficiaries who cannot share in the discharge of this responsibility but rather it is to exploit the patents jointly through the licensing agreement and after payment of certain expenses to distribute the royalties to the Grantors. Under section 1.5 of the Trust Agreement, the Grantors generally retain the right to vote on all Trust matters by a majority vote. Further, the Trust is not subject to special treatment under the Code. Therefore, the Trust is classified as a business entity under § 301.7701-2(a). Because the Trust has more than one member, it will be classified as a partnership for federal tax purpose, if it does not elect otherwise.

Based on the information submitted and the representations made, we also conclude that provided the Trust does not elect to be treated as other than a partnership, and also provided that the other requirements of § 1235 are satisfied, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patents held by the partnership or an undivided interest in the patents held by the partnership will be considered proceeds from the sale or exchange of a capital asset held for more than 1 year.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Joseph H. Makurath
Senior Technician Reviewer, Branch 7
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)