

Office of Chief Counsel
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date: August 22, 2007

to: Technical Advisor

from: Deputy Area Counsel (Industry Programs)

subject: Taxation of License Agreement

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Corp Z	=
Corp Z Officer 1	=
Corp Z Officer 2	=
Corp Y	=
Corp X	=
Corp W	=
Corp T	=
Corp S	=
Corp R	=
Corp Q	=
Corp P	=
Entity N	=
Entity M	=
Entity L	=
Project J	=

Project H	=
H Portfolio	=
H	=
G	=
F	=
E	=
D	=
C	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=
Year 9 Analysis	=
Year 10 Deal Summary	=
Use Agreement	=
("UA")	=
Equity Agreement	=
Supplemental Agreement	=
Agreement 1	=
Agreement 2	=
Option 1	=
Option 2	=
Option 3	=
Option 4	=
Option 5	=
Agreement 3	=
Agreement 4	=

Agreement 5	=
Agreement 6	=
Agreement 7	=
Agreement 8	=
Agreement 9	=
Agreement 10	=
Agreement 11	=
Agreement 12	=
Agreement 13	=
Agreement 14	=
ZZ	=
YY	=
XX	=
WW	=
TT	=
SS	=
RR	=
QQ	=
PP	=
NN	=
MM	=
LL	=
KK	=
HH	=
GG	=
FF	=
EE	=
DD	=
CC	=
BB	=
AA	=
item	=
items	=
Item 1	=
Item 2	=
Item 3	=
Item 4	=
Item 5	=
Item 6	=
Item 7	=
Item 8	=
Item 9	=
Item 10	=

Item 11 =
Item 12 =
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Item 14 =
Item 15 =
Item 16 =
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Item 21 =
Item 22 =
Item 23 =
Item 24 =
Item 26 =
Item 27 =
Item 28 =
Item 29 =
Item 30 =
Country A =
Country B =
Country C =
Country D =
Country E =
Country F =
Country G =
Country H =
Country J =

Country K =
State A =
=

All numbers and months/days without a specific legend above are replaced with **
(e.g., \$**, Ex. **, ** year.)

ISSUES

1. Whether the taxpayer's license agreement can be recharacterized as a sale agreement.
2. Alternatively, assuming the license agreement can be recharacterized as a sale agreement, whether it should be integrated with the taxpayer-reported I.R.C. § 351 transaction under which no gain or loss can be recognized.
3. Alternatively, assuming the license agreement can be recharacterized as a stand-alone sale agreement, whether a loss can be recognized in Year 10.

CONCLUSIONS

1. The license agreement cannot be recharacterized as a sale of the underlying intellectual property given the plain language of the agreement establishing it is a license, the licensor's limited rights in the intellectual property, the agreement language on the intent of the parties, the licensor's failure to transfer all monopoly rights, the licensor's retention of substantial rights, and the fact the grant is limited to an amorphous field of use.
2. If a sale agreement, the agreement would be integrated with the taxpayer-reported § 351 transaction under which no gain or loss can be recognized.
3. If a sale agreement separate from the § 351 transaction, no loss can be recognized in Year 10.

FACTS

In Year 10, Corp Z, a publicly held C corporation, entered into a transaction that included multiple integrally related steps ("Year 10 Transaction"). One of the steps of the Year 10 Transaction was the execution of a Use Agreement that licensed and sublicensed rights in H (as well as other intellectual property and intangibles) to a separate privately held company, Corp Y. Another step involved the execution of a Equity Agreement that helped the licensee under the Use Agreement acquire assets and cash in return for equity.

On its Year 10 Federal income tax return, Corp Z treated the Use Agreement as a license and the Equity Agreement as a tax free I.R.C. §351 exchange. During Year 11 and early Year 12, Corp Z did not notify the IRS of any change in position with respect to its Year 10 tax reporting while it was participating in an IRS Appeals Fast Track proceeding to determine the amortizable basis of certain , some of which was licensed in the Use Agreement.

Corp Z now claims that it erred in its Year 10 tax reporting, and that the Use Agreement was actually a stand-alone sales agreement that gives rise to a loss recognizable in

Year 10. To compute the amount of the loss, Corp Z derived an amount realized from its projections of the net present value of future contingent payments relative to four items licensed in the Use Agreement, and used the basis from the IRS Appeals Fast Track closing agreement.

I. **Ownership of H**

A. CORP T

B. Agreement(s)

C. CORP S

D. Collaboration with Corp W

1. Cross License

2. Royalty, and Milestone Fees

3. Intellectual Property Ownership

E. License from Entity N

F. Contract

Entity M

G. Corp Q

II. Year 10 Transaction

In Year 10, a number of parties entered into the Year 10 Transaction, specifically: (1) Corp Z; (2) Corp Q; (3) Corp Y; and (4) investors who held pre-existing interests in Corp Y.

Corp Z received equity in Corp Y, and future upfront, milestone and royalty payments from Corp Y and, in exchange, Corp Y acquired an exclusive license to use certain intellectual property,

A. Planning for the Year 10 Transaction

In a recent meeting with the IRS, Corp Z stated that the Year 9 Analysis was a presentation made to Corp Z's senior management to "sell" the idea of Project J and therefore the figures contained therein were optimistic, rather than realistic, projections. Corp Z also stated that there were no underlying studies, opinions, valuations, or reports for said analysis.

C. Implementation of Project J

Project J was implemented primarily by three agreements: (1) The Use Agreement, (2) The Equity Agreement, and (3) a Supplemental Agreement.

1. The Use Agreement

The Use Agreement was entered into on ** Year 10, by which Corp Z and Corp Q granted Corp Y certain licensing rights to Corp Z's H intangibles.

2. The Equity Agreement

On ** Year 10, Corp Z, Corp Y, and Corp Y's existing shareholders¹ (the "Existing Shareholders") entered into the Equity Agreement. Under this agreement, Corp Z and the Existing Shareholders agreed to contribute property to Corp Y in exchange for stock in Corp Y. All the contracting parties intended, and we have assumed for the purpose of this memorandum, that the exchange qualified as a tax-free exchange under I.R.C. §351.



3. The Supplemental Agreement

In addition to the Use Agreement and the Equity Agreement, on ** Year 10, Corp Z, Corp Q, and Corp Y executed a Supplemental Agreement.

D. Reporting of Project J



Corp Z treated the Use Agreement as a license on the Year 10 return by continuing to amortize it claims was sold to Corp Y, to the extent that the was determined to have an amortizable basis in the IRS Appeals Fast Track Proceeding.

III. Year 12 Closing Agreement

On ** Year 12, in a closing agreement resulting from the IRS Appeals Fast Track settlement, it was agreed that Corp Z had a non-amortizable basis in certain Corp S projects that were subject to I.R.C. §263 and an amortizable basis in other Corp S pursuant to I.R.C. §§59(e) and 174.

IV. Corp Z Claim

In ** of Year 12, Corp Z notified the IRS of its change in position, specifically that it now contends the Use Agreement was a sale agreement, not a license agreement as reported on its tax returns, with a claimed loss in Year 10 computed as follows:

\$ **	net present valuation of future contingent payments
(**)	263 basis per fast track settlement
<u>(**)</u>	59(e) basis per fast track settlement (remaining)
(\$ **)	

In support of its claim, Corp Z submitted a memorandum dated ** Year 12 (“Corp Z Submission”) contending that H , Corp X technology, Corp W technology and other intellectual property was sold to Corp Y via the Use Agreement, addressing the property collectively as “IP.”²

. . . Corp Z re-evaluated [the Use] Agreement against the backdrop of applicable case laws [sic] that provide [sic] general sale and exchange principles in order to make its final determination. [Fn. omitted][³]

Corp Z’s Submission asserts two general legal principles control the determination of whether the Use Agreement is a license or a sale: the intent of the parties and the substance of the transaction.⁴ Corp Z contends that, notwithstanding language to the contrary in the Use Agreement, it intended to sell, not license, the IP, claiming that the Year 10 Transaction evidences its true intent. Corp Z further contends the word “exclusive” modifying license and the terms relative to infringement suits and confidentiality imposed on Corp Y evidence the substance of the Use Agreement was a sales agreement.

Corp Z’s Submission further asserts:

Albeit true that Corp Z reserved the right to use the IP for TT and XX , these rights currently have minimal value to Corp Z as the Company has presently ceased all R&D activities in the area. None of the IP retained rights

² Corp Z Submission, at 1.

³ Corp Z Submission at 2.

⁴ Corp Z Submission at 2.

have led to the development of a successful product to date. [Fn. omitted] [⁵]

Corp Z did not support this assertion with a valuation of the retained rights, nor did Corp Z address why its corporate focus rather than the fair market value standard (hypothetical willing buyer/willing seller) would control the valuation.⁶ Rather, Corp Z's Submission argues in the alternative, as follows:

In arguendo, even if the retained IP rights led to the development of a product, separate bundles of rights in the same patent may constitute separate properties, each of which may be the subject of a sale. [Fn. omitted] In this case, Corp Z retained IP rights for a separate and distinct field, TT and XX, and transferred substantial IP rights to Corp Y for fields other than TT and XX. [Fn. omitted, emphasis in original][⁷]

The last omitted footnote cites to Rodgers v Commissioner, 51 TC 927 (1969), for support of Corp Z's contention that a field of use can be sold, without indicating the Tax Court subsequently declined to follow Rodgers, with the Commissioner (prior to the case being overruled) acquiescing in the result only on the grounds that the patent had no value outside of the territory of the grant.⁸ Rodgers v Commissioner, 51 TC 927 (1969), acq. In result, 1973-2. C.B. 1, declined to follow by, Kueneman v. Commissioner, 68 T.C. 609 (1977), aff'd 628 F.2d 119 (9th Cir. 1980).

Corp Z's Submission did not address its reasons for contending the Use Agreement was a stand-alone transaction. In support of present valuing the future contingent payments under the Use Agreement for immediate tax recognition, Corp Z asserts that closed transaction reporting, rather than reporting over time, applies.

Corp Z provided a valuation study dated ** Year 12 prepared by G. In that valuation study, G performed a discounted cash flow ("DCF") analysis and concluded that the present value of the payments Corp Z expected to receive under the Use Agreement was approximately \$**. G's study focused primarily on ** items, namely, Item 3, Item 23, Item 24, and Item 1, as of ** Year 12. Each of those items was assigned with a probability , which supposedly reflected the likelihood the item would become a marketable . In general, G 's DCF analysis consisted of three steps: first, project the royalty and milestone payments based on estimated sales and milestone events to be achieved by those four items in each year from ** to **; second, adjust each item's projected royalty

⁵ Corp Z Submission, at 3-4.

⁶ No valuation was provided to support Corp Z's theory that when the ** patents expire, it is unlikely that the know-how would have any value.

⁷ Corp Z Submission, at 4.

⁸ See 1972 AOD LEXIS 34 (1972) and WL 32763 *IRS AOD)(electronic private publication of Action on Decision text).

and milestone payments by its probability ; and third, use a discount rate of **% to compute the present value of the total probability-adjusted royalty and milestone payments. G stated that the sales and milestone forecasts, the ** items' probability , and the **% discount rate were furnished by Corp Z and that it did not independently verify the accuracy of that information. The IRS has not conducted its own valuation to determine the reliability of G's Report.

V. Use Agreement

A. Intent

B. Property Ownership

C. Grant of Rights

D. Additional Terms

VI. **Subsequent Development**

LAW AND ANALYSIS

I. Corp Z Cannot Recharacterize the Use Agreement

The plain and unambiguous language of the Use Agreement mandates the agreement be treated as a license, as addressed in Law and Analysis, Section I.B., below. Even if the law did not preclude recharacterization from a license to a sale based on the plain language of the agreement, Corp Z cannot sell what it does not own and cannot sell patents owned subject to preexisting licenses and agreements, as addressed in Law and Analysis, Section I.C., below.

The cardinal rule in interpretation of contracts is to ascertain the intent of the parties, with said rule applying to patent transactions. Pursuant to the clear and compelling language in the Use Agreement, the parties to the agreement intended that it be a license, not a sale. Thus, extrinsic evidence cannot be used to modify the stated intent in the agreement and recharacterize the license as a sale, as addressed in Law and Analysis, Section 1.D., below.

Alternatively, as addressed in Law and Analysis, Section I.E., below, Corp Z failed to transfer all monopoly rights in the intellectual property and retained substantial rights in the intellectual property so the agreement cannot be treated as a “sale or exchange” for tax purposes. As further addressed in Law and Analysis, Section I.E. (5), below, for the field of use transfer at issue, the law precludes recognition of the transfer as a sale.

A. Applicable Law

Whether the Use Agreement can be recharacterized turns on general principles of tax law as shaped by patent law and contract construction principles, not on I.R.C. §1235, given Corp Z is a C Corporation. §§1235(a) and (b). When Congress enacted §1235, it intended that C corporations be governed by existing law as if §1235 had not been enacted. S. Rep. No. 1622, at 441 (1954). Generally, in the case requiring a determination whether an agreement is a license or a sale of a patent, the rights surrendered or retained under the agreement control rather than the labels used. E. I. Du Pont de Nemours & Co. v. United States, 432 F.2d 1052, (3rd Cir. 1970); Allied Chemical Corporation v. United States, 370 F.2d 697 (2nd Cir. 1967); Rev. Rul. 58-353, 1958-2 C.B. 408. And “normally, the tax man can take the instrument as the parties put it together” Clark v. United States, 341 F.2d 691, (9th Cir. 1965) quoting, Pacific Rock & Gravel Co. v. United States, 297 F.2d 122, 125 (9th Cir. 1961).

(1) Impact of Patent Law

Both historic and current tax cases recognize the impact of patent law on the determination of whether a patent transaction constitutes a license or a sale for tax purposes. One such historic case is Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953), cited with approval by Congress when it enacted §1235. S. Rep. No. 1622, at 439 (1954). In addressing the issue of whether a patent agreement met the “sale or exchange” requirement of tax law, the Kronner court opined the issue 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.” 110 F. Supp. at 734.

The Kronner court cited Crowne Die & Tool Co. v. Nye Tool & Machine Works, 261 U.S. 24, 40 (U.S. Ill. February 19, 1923), and stated that tax law should follow Crowne 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 and, then, * * *. It is not safe, therefore, in dealing with a transfer of rights under patent law to follow implicitly the rules governing a transfer of rights in a chose of action at common law.”

Recognition of this distinction must be made when construing agreements transferring patent rights.

110 F. Supp. at 734 (emphasis added).

The quoted language from Crowne Die & Tool relied, in part, upon Waterman v. Mackenzie, 138 U.S. 252, 256 (1891). Kronner agreed with applying Waterman

pursuant to the reasoning in Eterpen Financiera Sociedad De Responsabilidad Limitada v. United States, 108 F. Supp. 100, 104 (Ct.Cl. Nov. 4, 1952),⁹ with the Kronner court first quoting Eterpen and then stating, respectively, as follows:

“ * * * 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 transaction, **factors which expressly negate the intent to make a transfer of the patent, the transaction cannot be held the equivalent of assignment.**”

We believe this to be the correct test to be applied in these situations.

110 F. Supp. at 735 (emphasis added).¹⁰

Prior to Kronner, it had already been well established for patent law purposes that United States patents are a product of United States statute. Bloomer v. McQuewan, 55 U.S. 539, 549 (1852). Thus, if a purported United States “patent” is not issued by the United States Patent and Trademark Office in accordance with the patent statutes, it is not a United States patent. When issued, the United States patent confers a monopoly, *i.e.*, grants the patentee the right to exclude others from making, using or vending during the life of the patent. Crowne Die & Tool Co., *above*. To constitute an assignment of a patent (sale), the transaction has to comply with the applicable United States patent statutes.

Waterman, 138 U.S. at 256, a landmark United States Supreme Court patent infringement case, interpreted patent statutes as requiring that the right to use, make and sell the patent be transferred to constitute an assignment (the Waterman Rule) and requiring that the transferor own the patent being transferred. *See* Abbott Laboratories v. Diamedix Corporation, 47 F. 3d 1128, 1131 (Fed. Cir. 1995) (applying the Waterman Rule). *See also* Vaupel Textilmaschinen KG v. Meccanica Euro Italia S.P.A., 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). In addition, an 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, sometimes referred to herein as “Patent Office.” 35 U.S.C. §§ 1, 100, 111, 121, 151, 261. While no particular form is required for a sale of a patent, the agreement must show a clear

⁹ In Eterpen (a tax withholding case) the simultaneous execution of a license and an option to acquire the licensed patent evidenced that the transaction was mere license.

¹⁰ Applying these principles to the Use Agreement mandates a license determination, while in Kronner the result was a sale.

and unmistakable intent to part with all right title and interest in the patent in accordance with Waterman Rule, as addressed further below.

Waterman is the primary case relied upon in historic and current non-§1235 tax and patent cases that opine on the question of whether a patent transaction is a license or sale. Thus, over the years, many tax and patent cases have cited, followed and/or distinguished Waterman; but, never did tax or patent law reject the Waterman interpretation that the patent statutes require that the rights to use, make and sell be transferred for an assignment. In certain circumstances, cases find that all three rights were transferred based on the intent of the parties when the documents are ambiguous (typically an unsophisticated transferor) or find that rights that were not transferred were not substantial so the transaction can be recognized as a sale. These circumstances do not exist for the Use Agreement.

An example of a corporate tax case determining whether a patent transaction was a license or a sale that predates §1235 and applies Waterman is The Cleveland Graphite Bronze Co. v. Commissioner, 10 T.C. 974, 988 (1948). After stating that the transaction document must be unambiguous and show a clear intent to part with the patent, the Cleveland Graphite Bronze court considered the language of a 1938 document that purported to grant a sole and exclusive license for the duration of the British patents at issue, but which was subject to a 1932 agreement. The court held that the two documents must be construed together and, looking at both documents, 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. This case reflects the general state of tax law for a C corporation transferor prior to the enactment of §1235, *i.e.*, if patent law precludes recognition of the transaction as anything more than a mere license, the transaction generally cannot be recognized as a sale for tax purposes.

(2) Impact of Contract
Construction Principles

Both historic and current tax cases recognize the impact of contract construction principles to determine whether a patent transaction constitutes a license or a sale. Specifically, the cases do not allow extrinsic evidence to vary the plain language of patent agreements that are not ambiguous.

Parke, Davis & Co. v. Commissioner, 31 B.T.A. 427 (1934), in considering the issue of whether an agreement relative to patents was a license or sale, acknowledged the agreement should be construed applying general contract interpretation principles, quoting from Peugh v. Davis, 96 U.S. 332, 336 (1877), which previously laid down the principle that:

“[t]he rule which excludes parol testimony to contradict or vary a written instrument has reference to the **language** used by the

parties. That **cannot be qualified or varied from its natural import, but must speak for itself**. The rule does not forbid an inquiry into the object of the parties in executing and receiving the instrument * * * “

31 BTA at 432 (emphasis added).¹¹

Patent cases have generally held that whether or not the language of a patent transaction is ambiguous, requiring extrinsic evidence to interpret, is a question of law. See Vision Information Services, LLC v. Commissioner, 419 F. 3d 554, 558 (6th Cir. 2005) (so finding in a case interpreting whether an agreement relative to patents was a license or a sale). See also Abbott Laboratories, above, 47 F. 3d at 1128 (“The legal effect of an agreement transferring patent rights is an issue of law that we review de novo.”)

Tax cases agree that for sophisticated taxpayers, when the plain language of the patent transaction is that of a license and the transactional document is not ambiguous, extrinsic evidence cannot be used to recharacterize a license as a sale, as further addressed in Law and Analysis, Sections I.B and I.D, below.

(3) Impact of Facts

While Corp Z attempts to cast its claim as a purely factual issue (in form a license and in substance a sale), such a cast impermissibly ignores the well established impact of patent law and contract construction principles on the tax treatment of patent transactions. In addition, Corp Z’s “fact” argument is based on case law and the language within the four corners of the Use Agreement, except for a reference to the Year 10 Transaction. See Facts, Section IV, Corp Z Claim, above (Corp Z’s reliance on case law and Use Agreement language). To the extent Corp Z claims (erroneously) that its Year 10 Transaction constitutes a “fact” for disregarding the form, the law addressed in this advice precludes a determination that, in substance, the intellectual property the subject of the Use Agreement was sold to Corp Y. Alternatively, if the Use Agreement could be recharacterized as, in substance, a sale transaction, the agreement would be integrated with the taxpayer-reported §351 transaction under which no gain or loss can be recognized. See Law and Analysis, Section II, below.

B. The Plain Language of the Use Agreement Establishes the Agreement is a License, not a Sale

Redler Conveyor Co. v. Commissioner, 303 F. 2d 567 (1st Cir. 1962), a case directly on point, held that clear and unambiguous agreements licensing intellectual property cannot

¹¹ In Parke, Davis & Co., the IRS objected to the admission of parole evidence on the grounds it was inadmissible to contradict the terms of a written instrument, with the court relying on the exception articulated in Peugh.

be recharacterized as a sale agreements (relying, in part, on E. W. Bliss Co. v. United States, 253 U.S. 187 (1920)).¹² The Redler 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 the 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 are 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).

Redler applied the Waterman Rule, quoting Waterman, 138 U.S. at 256, and interpreting Waterman as having

. . . laid down the rule for deciding whether a particular instrument is an assignment or license in the following language:

“The patentee or his assigns may, by instrument in writing, assign, grant, and convey, either, **1st**, the whole patent, compromising the exclusive right to make, use and vend the invention throughout the United States; or, **2nd**, an undivided part or share of that exclusive right; or, **3rd**, the exclusive right under the patent within and throughout a specified part of the United States. (citation omitted) 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 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, and no right to sue at law in his own name for infringement.”

303 F. 2d at 568-69 (emphasis added).¹³

¹² E. W. Bliss held that “palpably this is a mere license, not sufficient to sustain a suit for infringement.” 253 U.S. at 193. The Supreme Court stated: “While the legal effect of the terms used and not the name ... 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 the legal effect shall be.” 253 U.S. at 192.

¹³ Section 1235 is more restrictive than patent law for territorial transfers. See Kueneman v. Commissioner, 628 F.2d 1196 (9th Cir. 1980) (territorial transfers that qualify as an assignment for patent purposes do not automatically qualify under §1235). See also Treas. Reg. §1.1235-2(b)(1).

Redler stated, with respect to field of use grants in the agreements at issue in said case (issue further addressed in Law and Analysis, Section I.E., below) that:

More importantly, however, and indeed basically, the substance of the agreements does not belie but supports the foregoing inferences from the language used in the agreements and the conduct of Redler with respect to them. **The agreements do not purport to transfer either entire or undivided interests in the patents but instead only segregated rights to some but not all of the uses of the patents.**

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

As with the taxpayer in Redler, Corp Z is experienced and sophisticated with respect to patent transactions, as can be seen from considering Corp Z's role in developing Hs. The complex agreements with respect to the use and sharing of intellectual property listed in Exhibit ** to the Use Agreement further support this view of Corp Z.

The details and specificity of the ** page Use Agreement, with its numerous carefully crafted definitions, was obviously meticulously drafted with words of art by knowledgeable persons.

If the Use Agreement sold all of Corp Z's right, title and interest to the ** patents and the other intellectual property rights the subject of agreement, the Use Agreement would have so stated in unequivocal terms. Rather, in unequivocal terms, the Use Agreement repeatedly emphasized that Corp Z retained ownership and carefully restricted the rights granted to Corp Y in section after section of the Use Agreement.

The Use Agreement clearly does not purport to transfer all of Corp Z's right title and interest in over ** patents and all of its H know-how, with all right title and interest in the intellectual property retained. Looking at the legal effect of the plain language in the Use Agreement there can be no doubt this is a mere license from the plain and unambiguous language within the four corners of the document.

As in Redler, the Use Agreement states the transferor is granting a license, not transferring all right title and interest in the property. The Use Agreement words call the grant of rights a license. The Section of the Use Agreement where the grant paragraph is located, , repeatedly uses words that circumscribe the grant of rights. In fact, the very first sentence of the grant of rights paragraph, which sets forth the grant, plainly and unambiguously used words which set forth multiple limits on the granted right to use, establishing unequivocally that it is a carefully limited right to use for specific purposes, and making it abundantly clear that only a license is granted.

All of the words throughout Section ** and all other

parts of the Use Agreement, confirm that only a license is granted, reiterating the limitations to a license in the stated intentions of the parties, the retention of ownership by Corp Z and in all paragraphs in Section ** of the Use Agreement, with all other parts of the agreement consistent with, and confirming, a license. As in Redler, it must be presumed the carefully chosen words of art intended to mean what they say.

Stepping back and considering the Use Agreement as a whole, in both tenor and substance, the plain language of the Use Agreement grants only a license, with multiple, additional and extensive limits on the license, such as **making** the license subject to pre-existing licenses and agreements, **limiting** the license to the development and discovery in an amorphous and modifiable field of use, **requiring** that the development and discovery use items and property in which Corp Z retained significant rights, **placing** onerous obligations on Corp Y with any failures causing revision of the licensed rights to Corp Z and **including** additional restrictions.

The language used in the Use Agreement speaks for itself and cannot be qualified or varied from its natural import. Peugh, 96 U.S. at 336.

The Redler court noted that the taxpayer's subsequent tax return treatment confirmed the court's determination that the agreements at issue in said case were licenses. As in Redler, Corp Z's subsequent acts confirm the Use Agreement is a license. Corp Z treated the Use Agreement as a license on its Year 10 and Year 11 tax returns. Throughout an IRS Fast Track proceeding during Year 11 and early Year 12, Corp Z continued to pursue tax benefits as a license, i.e., determination of the amortizable basis. Corp Z would not have continued to press its claim to amortization if it had sold the property ** years prior to the settlement of the Fast Track proceeding. By its silence in the IRS Fast Track proceeding with respect to the Use Agreement being a sale agreement, Corp Z was, in effect, again representing to the IRS in Year 12 that the Use Agreement was a license, and continued to be a license. In addition, Corp Z's subsequent agreements further confirm Corp Y was merely a licensee. One subsequent agreement terminates Corp Z's rights to sublicense some of the subject matter of the Use Agreement to Corp Y and one subsequent agreement confirms that Corp Z had sufficient rights to sublicense some of the subject matter of the Use Agreement to Corp Y.

The Redler court's reliance on the plain language of the document is not an anomaly. A more recent case addressing the license versus sale issue for an unambiguous agreement, such as the Use Agreement, is Vision Information Services, LLC v. Commissioner, 419 F. 3d 554, (6th Cir. 2005). In interpreting a patent license, the court stated whether the document is ambiguous is a question of law, with interpretation of ambiguities a question of fact. The court found the plain language of the contract provides for a license by using the terms license and licensee, with no language

supporting a sale characterization, so there was no reason to consider extrinsic evidence, quoting from Redler Conveyor Co. v. Commissioner, 303 F. 2d 567, 569 (1st Cir. 1962). As in Vision Information Services, there is no language in the Use Agreement supporting a sale characterization and no reason to consider extrinsic evidence. Thus, applying these principles, as a matter of law, the Use Agreement would not be ambiguous and cannot be recharacterized as a sale agreement.

Redler's reliance on the plain language in patent agreements also has historic precedent. In Commissioner v. Celanese Corp., 140 F. 2d 339 (D.C. Cir. 1944), the IRS determined deficiencies against Celanese for failure to withhold taxes, with the case turning on whether the payments were royalties for the use of the patents or for the purchase of the patents. The court held the transaction to be a sale because; considering the words in the document, there could be no doubt that the parties intended a sale, not a license.¹⁴ Celanese Corp, as Kronner, above, was cited with approval by Congress when it enacted §1235. S. Rep No. 1622, at 439 (1954). For the Use Agreement, considering the words in the document, as did the court in Celanese Corp, there can be no doubt that the parties to the Use Agreement intended a license, not a sale.

Allen v. Werner, 190 F.2d 840, (5th Cir. 1951), also addressed the role of contract construction principles in patent transactions. The issue on appeal of that income tax refund case was whether the trial court correctly determined the agreement that the taxpayer claimed was a sale of the patents was ambiguous, thus allowing the admission of parole evidence to establish the intent of the parties. The Fifth Circuit found the trial court correctly determined the agreement was ambiguous because a subsequent paragraph contradicted the grant of rights. For Corp Z, there are no internal inconsistencies in the Use Agreement between the license language in the grant and the other language in the Use Agreement as in Werner; rather, all of the Use Agreement language indicates a license whether considered as individual parts or as a whole. Each and every term of the Use Agreement is in conformity with the grant of a mere license, not a sale. The grant of rights in the Use Agreement, clearly and repeatedly included restrictive language that evidences a license.

There are cases that cite to Waterman, above, for the proposition that use of the word "license" in an agreement is not controlling. First, it is not an isolated label of "license" that is relied upon in rendering this advice; rather, it is the plain language of the Use Agreement as a whole. Second, Waterman rejected a characterization as sale notwithstanding the words in the agreement because the seller did not hold sufficient rights in the patent to sell, as addressed in Law and Analysis, Section 1.C, below, with regard to Corp Z. Third, Waterman did not reject the general principles of contract construction. Rather, as stated in Switzer v. Commissioner, 226 F. 2d 329, 330 (6th Cir.

¹⁴ In Celanese Corp. executed assignments of each patent at issue were accepted and recorded in the United States Patent Office. 140 F.2d at 341.

1955), with respect to the interpretation of Waterman: “whether the instrument constitutes an assignment or license does not depend upon the name by which is called, but upon the legal effect of its provisions.” See Eterpren, above at 104 (finding that Waterman looked to the legal effect, not the name, to ascertain the true nature of the agreement).

The Switzer court held that an exclusive license could not be recharacterized as a sale agreement after finding the “Memorandum of License Agreement,” referred to the parties as licensor and licensee and provided that the licensee should forward royalties from sublicenses to the licensor. The Switzer court rejected the taxpayer’s reliance on the modifier “exclusive” as determinative, and noted the taxpayer had reported the royalties as ordinary income on its tax return. The legal effect of the Use Agreement, as with the document at issue in Switzer, is that of a license.

In addition, the Use Agreement provides that state A law applies, with said law agreeing with the general principles of contract law stated above, as follows:

Thus, the true nature of the Use Agreement, as shown through the plain language of the agreement, is a license. This conclusion is drawn, not just from the use of the words “license” and “sublicense” (although relevant); but, from the carefully chosen words that limit Corp Y to a license when the document is considered as a whole looking at all of the language within the four corners of the document. The plain language of the Use Agreement is clear and unambiguous without internal inconsistencies, and extrinsic evidence cannot be allowed to vary the clear and compelling language of the license agreement. Peugh, 96 U.S. at 336. The plain and unambiguous language of the Use Agreement precludes recharacterizing the Use Agreement.

**C. Corp Z Cannot Sell What it Does Not Own, and
Cannot Sell Patents Subject to a Pre-Existing License**

Corp Z's Submission in support of its claim only addresses the subject matter of the Use Agreement collectively as "IP," without separately addressing the individual properties that Corp Z contends it sold to Corp Y. See Facts, Section IV, Corp Z Claim above (Corp Z's Submission in support of its claim). Corp Z's valuation submitted to support its assertion as to the amount realized is limited to ** items, without explanation as to why it would only value ** items when the subject matter of the Use Agreement is so extensive. See Facts, Section IV, Corp Z Claim, above (valuation study). Thus, it may be that Corp Z is only seeking to recharacterize the Use Agreement as a sale for some, but not all, of the subject matter of the agreement. Regardless of the breadth of Corp Z's recharacterization claim, to the extent that Corp Z claims that it sold patents that it did not have sole right, title and interest in, Corp Z cannot have sold the property. To the extent Corp Z claims patents can be sold subject to preexisting licenses and agreements, Corp Z errs.

Pursuant to the terms of the Use Agreement, rights were granted (licensed) to Corp Y **subject to** pre-existing licenses and agreements **and** "under the Licensed IP."

With respect to said Licensed IP, the Use Agreement stated that:

While the clarification that Corp Z retained right, title and interest is sufficient to determine that it is a grant of a mere license "under the Licensed IP," it is worthwhile to look at the subject matter of the Use Agreement by categories.

(1) Sublicensed IP

The Sublicensed IP (patents Listed on Exhibits ** and ** of the Use Agreement) is defined as:

As a mere licensee, Corp Z cannot sell patents belonging to another. See Waterman (the transaction cannot rise to the level of the sale if, pursuant to transactions recorded in the patent office, the purported seller does not hold title to the patent); Prima Tek II, LLC v. A-Roo Co., 222 F. 3d 1372, 1377 (Fed. Cir. 2000) rev'g Prima Tek III, L.L.C. v. A-Roo, 1999 WL 33582120 (S.D.Ill. Mar 16, 1999) (one cannot sell what does not own). Thus, to the extent Corp Z contends it sold patents belonging to another, Corp Z errs.

(2) Patents listed on Exhibit ** of the Use Agreement

For the ** patents listed in Exhibit ** of the Use Agreement, Corp Z failed to establish that it transferred all right title and interest in pre-existing licenses and agreements that were entered into with respect to the ** patents. Patents that Corp Z owns that are subject to preexisting licenses and agreements cannot be sold subject to the preexisting licenses and agreements.

First National Trust and Savings Bank of San Diego v. United States, 200 F. Supp. 274 (S. D. Ca. 1961), considered whether a grant of an exclusive license to make, use and sell, subject to pre-existing licenses, could be considered a sale for tax purposes. The court held that for a patent transaction to qualify as a sale of the patent, there must be a grant of all substantial rights given by the patent when issued, not just the right's remaining in the transferor at the time of the transfer. 200 F. Supp at 281.¹⁵

First National Trust and Savings Bank of San Diego is criticized by Bell Intercont'l Corp. v. United States, 180 Ct. Cl. 1071, 381 F. 2d 1004, 1013 (1967), with Bell relied upon in Corp Z's Submission. Bell analogized a sale of a patent subject to a pre-existing retained license to the sale of land subject to an easement, and found a patent could be sold notwithstanding the fact the seller had previously licensed the patent and continued

¹⁵ The case addressed a 1951 payment under §117(q) of the 1939 Code (enacted after §1235 of the 1954 Code to make §1235 retroactive to 1950), but that does not detract from the applicability of the holding on pre-existing licenses.

to receive royalties from the previous license that were not assigned as part of the transaction. Bell did not support its sale determination by analyzing or distinguishing patent law; rather, Bell cited to other tax cases that do not actually support the Bell determination. In the Bell-cited case of Rollman v. Commissioner, 244 F. 2d 634, 641 (4th Cir. 1957), the court stated the pre-existing licenses were with respect to a separate patent not owned by the taxpayer's whose payments were at issue. General Aniline & Film Corp. v. Commissioner, 139 F. 2d 759 (2d Cir. 1944), also cited by Bell, is a tax withholding case that held non-contingent payments were not subject to withholding, with dicta commentary to the effect that the court "believed" all right title and interest passed, dropping a footnote speculating that at the time of the transfer a transferee could probably simultaneously grant a license back to the transferor. Said dicta, and the speculative footnote, were not germane to the grounds the court relied upon to hold that withholding was not necessary.

In addition, the Bell sale determination (there are multiple determinations in the case, with different cases citing Bell for different reasons) was shaped by the fact the pre-existing license was a cross license required of all airplane manufactures in the Manufacturers Aircraft Association and the exigencies of the World War II. Moreover, Bell is not on point for the facts at hand. As stated in Vision Information Services, LLC, above, 419 F. 3d at 560, n. 1, Bell, and Hooker Chems. & Plastics Corp. v. United States, 219 Ct. Cl. 161, 591 F. 2d 652, 658 (1979)¹⁶ (discussed below), address the limited issue of "whether the granting clause in the patent agreement is so broad that in legal effect it is an assignment even though the parties call it a license and the payments there under royalties." The grant clause in the Use Agreement is not broad; it is a limited grant, meticulously circumscribed repeatedly in the grant language, with the limits on Corp Y's use reiterated in the retained rights and the obligations imposed in Article **.

To the extent there are pre-existing licenses or agreements for the ** patents, or Corp Z retains the right to use the patents, Corp Z cannot sell that property. See Crowne Die & Tool (rejecting recognition as an assignment when the transferor retained the right to use); Abbott Laboratories v. Diamediz, 47 F.3d at 1132 (transferring a worldwide exclusive license subject to pre-existing licenses does not assign the patent). See also Walen v. United States, 273 F. 2d 599, 601 (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). In addition, it is noted that Corp Z failed to establish that assignments of each of the ** patents were accepted and recorded in the United States Patent Office. See Cleveland Graphite Bronze Co, 10 TC at 989 (distinguishing Celanese Corp, 140 F.2d 339 (D.C. Cir. 1944) on the grounds that in Celanese Corp an assignment of each patent was accepted and recorded in the United States Patent Office, as well as on the clear and unmistakable language to part with all right title and interests in the patents).

¹⁶ There exists is a non-published supplemental document for this case, Hooker Chems. & Plastics Corp. v. United States, 221 Ct. Cl. 988, 618 F. 2d 123 (Ct.Cl. Sept. 14, 1979).

(3) F

To the extent Corp Z is, instead, contending it sold the “F,” that were either patented (addressed above) or unpatented (addressed below) the terms of the Use Agreement contradict that contention. First, Corp Z does not warrant that it owns the F. Second, the definition of F overlaps, in part, with the definition of “Licensed IP,” addressed above. Third, Corp Z retained a field of use of undefined elastic proportion in F, as addressed in Law and Analysis, Section 1.E. below.

(4) Know-How

For the know-how, Corp Z failed to provide sufficient information to establish that it rises to the level of property that can be sold.

In addition, Corp Y’s “exclusive” right to the know-how is as limited as all of its other rights (e.g., subject to Corp Z’s field of use, pre-existing agreements, obligations to produce on short time lines, and patents held by others). Moreover, Corp Y’s rights to the know-how terminates when the agreement terminates, reverting back to Corp Z. To the extent the know-how is property, the know-how is not sold because the transfer is not in perpetuity, as addressed in Law and Analysis, Section 1.E, below.

(5) Agreement as a Whole

Finally, to the extent Corp Z contends it sold only some of the ** items identified as E,¹⁷ the only property Corp Z represents and warrants (for ** years) that it owns, Corp Z still errs. Corp Z cannot sever from the closely intertwined bundle of rights licensed to Corp Y a few items and convert the Use Agreement, for a few items, into a sale agreement. The law does not, and cannot, allow Corp Z to disregard the Use Agreement as-a-whole and cherry pick individual items to create tax benefits that the agreement as-a-whole precludes.

In addition, the sum of the parts is greater than the whole, and it would be impermissible to consider each part individually. For example, the patents and know-how licensed to Corp Y are probably platform technology and/or blocking technology that precludes Corp Y’s use of, or further development of, E without the licenses granted in the Use Agreement, hence the limitation to the license being “under” the licensed IP. Moreover, a patent is an intangible which provides its owner with the right to exclude others from making, using and selling. Vaupel Textilmaschinen KG, 944 F.2d at 875. Corp Z has

retained the right to exclude others, as addressed in Law and Analysis, Section 1.E, below.

D. The Parties Intended that the Use Agreement be a License

Corp Z's Submission relies on Hooker, cited above to avoid the stated intent in the Use Agreement; but, disregards that the Hooker court, despite finding ambiguities within the document, relied upon the language to establish the intent of the parties. As stated in Pickren v. United States, 378 F. 2d 595, 599-600 (5th Cir. 1967), a case relied upon by Hooker:

The cardinal rule in the interpretation of contracts is to ascertain the mutual intention of the parties and then, so far as is possible so to consistently with legal principles, give effect to that intention. Where the meaning of the contract is not plain and its terms are ambiguous, the court should place itself as nearly as may be in the position of the parties when their minds met upon the terms of the contract, and from a consideration of the writing itself, of its purposes, and of the circumstances which attended its making, endeavor to ascertain the true intent of the parties. . . . consider[ing] the language of the contract in its entirety [and] the terminology used may be of great importance.

Thus, if the intent is clear from the plain language of the contract, the language still controls even in an ambiguous document. See Vaupel Textilmaschinen KG v. Meccanica Euro Italia S.P.A., 944 F. 2d 870, 874-75 (Fed Cir. 1991) (quoting from Nicolson Pavement Co. v. Jenkins, 81 U.S. 452, 456 (1871):

“An assignment of an interest in an invention secured by letters-patent, is a contract, and like all other contracts is to be construed so as to carry out the intentions of the parties to it.”

See also Kronner, above, 110 F. Supp. at 734 (“...**the best evidence of this intention is the very words used in the contract.**”) (emphasis added) and Commissioner v. Hopkinson, 126 F.2d 406, 410 (“Their intention, **as shown by their language in the contract**, was to have the ‘seller’ sell and ‘purchaser’ buy the property”)(emphasis added). Both Kronner and Hopkinson were cited with approval by Congress as existing law when §1235 was enacted. S. Rep. No. 1622, at 439 (1954).

The very words used in the Use Agreement state the parties intended to enter into a license.

The parties re-confirmed that intent in the next section on property ownership, reiterating that

The stated intent to merely license the property the subject of the Use Agreement must be accorded the deference the compelling words command. There can be no doubt a license was intended. Not one word in the balance of the Use Agreement equivocates on the stated intent, with all terms of the Use Agreement consistent with a mere license.

As stated above in Law and Analysis Section I, above, extrinsic evidence explaining the object of the parties can be considered, but not to vary the plain, clear and unambiguous language of the agreement. Corp Z errs when it claims the Year 10 Transaction establishes its intent to sell notwithstanding the language in the Use Agreement. First, that stated intent is in stark contrast to the carefully selected words in the Use Agreement, and cannot nullify the plain language. Second, the most the Year 10 Transaction evidences is that the Use Agreement cannot be considered a stand-alone transaction because it is part of a corporate reorganization, be it a taxable or tax free event as Corp Z reported on its Year 10 tax return. Third, Corp Z obtained an equity interest in Corp Y rather than actually divesting itself of all interest

E. Corp Z Fails the Rights Analysis Applicable to C Corporation Patent Sales

In considering transactions that are **not** clearly and unambiguously licenses, the law looks at what the transferor **gave up** and what the transferor **retained**. This two-step analysis was well articulated in Mros v. Commissioner, 493 F. 2d 813, 816 (9th Cir. 1974) in the context of a §1235 case, with reference to support in non-§1235 cases.

In addressing the first question, the Mros court opined that failure to transfer all monopoly rights in the patent precludes sale treatment. In addressing the second question, the Mros court opined that the retention of substantial rights of value precludes sale treatment. See Abbott Laboratories above (recent patent case applying the substantial rights analysis).

Thus, if the Use Agreement were to be considered ambiguous, looking at what Corp Z **gave up**, the transaction cannot be a sale because either Corp Z could not, or did not, transfer all monopoly rights, e.g., Corp Z held an interest in the property as a mere licensee or the property was subject to pre-existing licenses and agreements. Looking at what Corp Z **retained**, it is even more evident that the Use Agreement cannot be a sale because Corp Z retained numerous substantial rights in the ** patents, projects, E, F, Licensed IP, Sublicensed IP, and Corp Z know-how.

The rights generally considered by courts when evaluating patent and know-how transactions using the Mros test, as here determinative, are addressed, below.

(1) Know-How Must Be Transferred In Perpetuity

If a transfer of intellectual property is not in perpetuity for know-how, the transferor will be found to have retained substantial rights that preclude sale treatment. In Pickren, cited above, the court held that a transfer of know-how for 25 years was not a sale, stating that know-how was sufficiently akin to patents to apply patent law by analogy. 387 F.2d at 599. The taxpayer had entered into a 25 year agreement with respect to secret formulas that competitors had not been able to replicate which granted an exclusive license to manufacture, use and sell, with a requirement that the transferee could not reveal or divulge the formulas. The agreement was denied sale treatment because the know-how could have a life longer than 25 years so all rights were not transferred because the know-how was not transferred in perpetuity. 387 F.2d at 600.

In Taylor-Winfield Corp. v. Commissioner, 57 T.C. 205 (1971) aff'd 467 F.2d 483 (6th Cir. 1972), the court held the transfers of patents and know-how at issue in said case were not sales because all substantial rights were not transferred. The court noted that the transfer of know-how is not covered by the internal revenue code or regulations, but found it to be well settled law that know-how is treated similar to patents. 57 T.C. at 213. The court then found the taxpayer's retained rights of use "inconsistent with the granting of a perpetual right to use the know-how beyond the term of the agreement." 57 T.C. at 218. The court further stated the documents showed "a studied effort on the part of petitioner to retain control over its patents, patent applications, trademarks, trade names, and know-how mentioned in the agreements." 57 T.C. at 218. The court rejected testimony to the contrary as "conclusory, interpretational, and contrary to the clear language of the agreements." 57 T.C. at 220.

As in the Taylor-Winfield documents, the Use Agreement evidences a studied effort on the part of Corp Z to retain control of the know-how. Corp Z's arguments to the contrary are conclusory and contrary to the plain language in the Use Agreement. Corp Z's argument that it transferred a perpetual right to the know-how by speculating that once the patents expire it is unlikely that the know-how will retain any substantial value is even less tenuous than bare conclusions. Mere speculation that know-how invariably has no value when patents expire cannot nullify well established case law requiring the know-how be transferred in perpetuity for a sale.

The Use Agreement included know-how, but did not transfer the know-how in perpetuity in that the contract terminated, at the latest, when the last patent expired.

At expiration, all know-how rights reverted to Corp Z . Thus, by virtue of the termination provisions that did not transfer the know-how in perpetuity, and the other time limits that are less than the lives of the patents, the Use Agreement is precluded from being recharacterized as a sale agreement for any know-how.

(2) Patents Must Be Transferred for the Duration of the Patents

If a transfer of a patent is not for the duration of the patent, the transferor will be found to have retained substantial rights that preclude sale treatment. Oak Manufacturing Co. v. United States, 301 F. 2d 259, 263 (7th Cir. 1962).

The Use Agreement sets short time limits on the duration of the purported exclusivity for uses of the patents in ** of Corp Y's purported "exclusive" fields of use. Corp Y was granted only a ** year "exclusive" license in XX

For all other uses, after ** years Corp Z could conduct Development or Commercialization with respect to any H-based products "in any field outside of the Corp Z Field".

The word "exclusive" is in quotes because, from the date of the execution of the Use Agreement, Corp Y never had exclusivity in its field of use. At all times Corp Z could develop and commercialize the Item 20-related items even if in the Corp Y field, with that retention ubiquitous throughout the Use Agreement. At all times Corp Z could develop and commercialize TT in Corp Y's "exclusive" field of use. At all times, Corp Z could use all patents in Corp Z's field of use.

Thus, while the first sentence of the first paragraph of the grant does have the word "exclusive" the other words in said sentence limit the term so no exclusivity, or sale, is extended to Corp Y. The transfer is for less than the duration of the patents and for less than all rights in the patents.

(3) The Transferor Cannot Retain Dominion & Control

When a transferor retains dominion and control of the intellectual property, the transfer cannot be a sale. Such a situation was addressed in Oak Manufacturing Co, above. The court held the transferor did not intend to transfer ownership of the patents given the control the transferor retained. In addition, the court found the phrase "sublicense others hereunder" to be indicative of the parties' intent to enter into a license. The Use Agreement uses a similar phrase and Corp Z retains dominion and control of the subject matter of the Use Agreement.

Schmitt v. Commissioner, 271 F. 2d 301, 304 (9th Cir. 1959), also addresses a situation where too much control was retained by the transferor. The transferee had affirmative duties, with the court stating "realistically considered, they more closely resemble a licensor's control of a licensee than an assignor's sale of 'all substantial' property rights." 271 F. 2d at 307. See Allied Chemical Corporation v. United States, 370 F.2d 697 (2nd Cir. 1967 (the aggregate of rights and controls retained precluded sale treatment).

Through the obligations imposed on Corp Y to advance Products on an expedited time frame (addressed further below), **and** the other retained rights, such as the Corp Z right to pre-empt partnership opportunities, the Corp Z right of first refusal for inventions (with surcharge royalties if Corp Z does not opt to license the invention), the reporting requirements imposed on Corp Y and the overall bundle of rights that Corp Z retains gives Corp Z dominion and control of the property it contends was sold via the terms the Use Agreement. Just as in Oak Manufacturing Co, Schmitt and Allied Chemical, this continued dominion and control precludes sale treatment.

Corp Y is subjected to short time frames:

. If Corp Y fails to meet these short time frames, what rights Corp Y was licensed revert to Corp Z.

If Corp Y meets the time frames for _____ and keeps its license, more obligations are imposed. Corp Y must push ** Products to \$ ** in annual revenues or one Product to \$ ** in annual revenues to continue to keep its license. _____ During the discussion of Project J, such a “hit” would have increased the net present value of Corp Z’s ** % equity interest in Corp Y to \$**-**. If Corp Y asks for relief from these obligations, what rights Corp Y was licensed revert to Corp Z.

If Corp Y fails to meet any of the above-described obligations, it is in material breach and Corp Z can unilaterally terminate the license. _____ If Corp Y were to meet the imposed obligations, Corp Z then can step in and pre-empt any successful partnership opportunity Corp Y may create. _____ If Corp Z doesn’t substitute itself for a potentially successful partner and Corp Y’s partnership results in a marketable Product, Corp Z receives an increased royalty from sales of the Product _____ and the option to negotiate for territorial rights. _____ .

In addition, Corp Y must file quarterly reports _____ and is subject to audit by Corp Z _____. The audit _____ is in addition to the monetary reports and audit of such. _____. Then, there is also Corp Z’s right to expand Corp Z’s field of use, which automatically reduces Corp Y’s field of use. _____ Moreover, Corp Z can unilaterally develop in Corp Y’s field as long as Corp Z separately markets and prices _____

Corp Z's Submission claims that its extensive controls amount to no more than a security interest, arguing that it would be able to cancel the license unilaterally and at will if more than a security interest was retained, citing to the bankruptcy limitation on termination. First, at will termination is only one of many retained rights the courts look at, with failure to include an explicit "at will" termination not the sole touchstone for any court decision. Second, Corp Z sets up a false positive when it focuses on the fact that the agreement provision allows termination for a condition subsequent such as bankruptcy. Neutral termination provisions, such as bankruptcy over which Corp Z has no control, are not of concern to the issue being addressed. While Corp Z's Submission further claims that Corp Y right to sublicense evidences a sale, Corp Z disregards that, like all other granted rights, the right to sublicense is a limited right and all sublicenses revert to Corp Z on termination. Moreover, as noted above, the right to sublicense confirms the grant is a license, not the opposite interpretation argued by Corp Z.

(4) The Transferor Cannot Retain Right to Indulge Infringements

Corp Z's Submission relies heavily on the terms in the Use Agreement with respect to the right to sue for infringement, contending the Use Agreement transfers all rights with respect to suits for infringement. Corp Z errs.

In Intellectual Property Development, Inc. v. TCI Cablevision of California, 248 F.3d 1333 (Fed. Cir. 2001), the transferor transferred an exclusive license, but the agreement was found not to be a sale because, among other reasons, the transferee did not obtain a right to **indulge**, i.e., permit, infringement. The right to indulge infringement was the critical touchstone precluding a finding that the right to sue was fully transferred. 248 F.3d at 1341

Pursuant to the terms in the Use Agreement, if Corp Y doesn't prosecute an infringement within # days, Corp Z can sue. Thus, Corp Y was not granted the right to indulge infringement; rather, Corp Z retained the right to exclude all others from using the property the subject of the Use Agreement. To the extent that right to sue for infringement was never Corp Z's, e.g. Corp X and Corp W patents, Corp Z did not grant Corp Y the right to sue in the names of the other patent holders.

The value of patents lies in the right to exclude others and Corp Z guarded that right carefully, retaining the right to sue infringers if Corp Y did not, and retaining the right to preserve all patents that Corp Y developed even if Corp Y did not want the patents.

(5) The Transferor Cannot Retain a Field of Use

Generally, the transfer of a field of use cannot constitute a sale. See Redler, above, 303 F.2d at 569 (rejecting a transfer of a field of use as a sale because "The rights transferred were only segregated rights to some but not all the possible uses of the

patents. “). See also Waterman, 138 U.S. at 256 (at a minimum an undivided interest in the entire patent for a territorial area must be transferred).¹⁸

In Schmitt, above, where one of the years at issue, 1949, was not subject to either §1235 or §117(q),¹⁹ the court stated the general law is well established.

An assignment of the exclusive right to manufacture, use, and sell a patented article within the United States or a specified area thereof amounts to a sale Anything less is a license. . . . A transfer which is not exclusive, or is limited (other than territorially), becomes a license and not an assignment.

271 F. 2d at 304.

There is a **limited** tax law case-based exception to the general rule when **only** a non-substantial field of use is retained. Carruthers v. United States, 219 F.2d 21, 24 (9th Cir. 1955), a case which addresses this limited exception, considered a non-substantial retained field of use that had no value. The Ninth Circuit pointed out that the right to exclude others from making, using or selling the invention in all practical fields of use that are of value is a part of the grant which gives existence to and defines the property. However, Corp Z retained the right to exclude, as addressed above, so cannot fit within this limited case-based exception.

In addition, to fall within the limited tax law case-based exception, the transferor must **prove** that the non-substantial retained fields of use had no value at the time of retention. See Young v. Commissioner, 269 F. 2d 89, 93 (2nd Cir. 1959) (the transferor bears the burden of proving its retained field of use lacked value). Corp Z’s conclusion that none of its Reverting Know-How, none of its retained rights in ** patents, none of its field of use, and none of the other retained rights (individually or as a whole) have value was not supported by a valuation report applying the well established hypothetical willing buyer/willing seller standard. Rather, Corp Z relied on case law to recharacterize the Use Agreement. In addition, Corp Z’s conclusion that none of its retained field had value is contradicted by known facts. Corp Z continued to market products in its retained field. Corp Z’s known expenditures to purchase H were significant, e.g., in Year 3, Corp Z contributed \$** to Corp S to pursue H and, in Year 7, paid another \$** to acquire further rights in Corp S’s H .

Also, as stated in Walen v. United, 273 F.2d 599, 602, n.3 (1st Cir. 1959), **if a field of use can be sold, it must be “a measurable, identifiable share, and not of an undefined elastic proportions.”** (emphasis added) The Corp Z Field is not limited

¹⁸ See Treas. Reg. § 1.1235-2(b)(iii) (for holders within §1235 a field of use cannot be sold).

¹⁹ In 1956, Congress retroactively amended the 1939 Code by the addition of I.R.C. § 117(q) to, in effect, make § 1235 of the 1954 Code retroactive to 1950. S. Rep No. 1941 (1956), 1956-2 C.B. 1227, 1229.

measurable and identifiable, being a field of elastic proportions. Corp Z can expand its field , with Corp Z's expandable field including, but not limited to, ZZ use ; TT use of H-based products ; XX use of H-based products after a ** year hiatus ; H-based products for any use after a ** year hiatus ; SS use in specified circumstances ; and Item 20 at all times . On its face, by the plain language in the Use Agreement, this multi-faceted broad field cannot be considered anything but substantial even without an appraisal or taking into account the unlimited potential for further expansion (assuming such limitless potential could be valued).

Moreover, given the breadth of the retained field, Corp Z could easily “spin off” one or more licenses of its retained field and “create” more “monopolies;” a possibility that would clearly violate the well established purpose of Congress when the patent statutes were first enacted. This purpose was quoted in Crowne Die & Tool Co., *above*, from Chief Justice Taney’s opinion in Gaylon v. Wilder, 51 U.S. 477, 10 Hou. 477, 13 L. Ed 504 (U.S. N. Y. Dec. Term 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. at 38 (emphasis added).²⁰

Corp Z’s attempt to create an assignable interest in patents via a contractual field of use disregards the fact that United States patents are created by United States statute and issued by the United States Patent and Trademark Office, with assignments of patents dictated by United States patent statutes (as construed by case law).

In contrast, the contractual right to use a patent, a license, is not a right issued by the United States Patent Office (nor are mere licenses submitted to said office for acceptance and filing); however, pursuant to Congressionally approved historic case law and current tax cases, while an assignment of a patent by a C corporation is a “sale or exchange” for tax purposes, a C corporation’s grant of a mere license in a patent, *i.e.*, a right to use, does not constitute a “sale or exchange” of the underlying patent (and by case-law extension the know-how). As a mere license of a field of use in the underlying intellectual property, the Use Agreement must be treated as such for tax purposes.

II. Alternatively, the Step Transaction Doctrine Applies and the Use Agreement is a Step in the Year 10 Transaction

Assuming, *arguendo*, both that the Equity Agreement qualified as a I.R.C. § 351 non-taxable exchange (as reported on Corp Z’s Year 10 tax return)²¹ and that the

²⁰ Crowne Die & Tool rejected an interpretation of patent statutes that allowed a patentee to create the right in others to sue infringers solely in their own names while the patentee retained the right to sue solely in its own name.

consummation of the Use Agreement constituted a sale in which Corp Z transferred all substantial rights in the patents and know-how subject to such agreement, the tax treatment of the transfers described in the Use Agreement is also governed by § 351. As discussed in Law and Analysis Section II.A. below, a transfer of property to a corporation under § 351 and a purported sale of property to such corporation will be integrated and treated as a single § 351 transaction where such transfers are part of the same overall plan. Because the facts demonstrate that the Use Agreement and the Equity Agreement were entered into as part of an integrated transaction, § 351 applies to both the Use Agreement and the Equity Agreement (assuming § 351 otherwise applies). Accordingly, Corp Z cannot recognize its claimed loss, and payments received in exchange for the patents and know-how will be treated as boot pursuant to § 351(b).

Integrating the Use Agreement with the § 351 transaction (i.e., the Equity Agreement) is consistent with the Service's published guidance regarding the transfer of intellectual property for § 351 purposes, as the Service has ruled that a grant of "all substantial rights" in intellectual property constitutes a transfer of property for § 351 purposes. See Rev. Rul. 64-56, 1964-1 C.B.133 (grant of technical know-how in perpetuity qualifies as transfer of all substantial rights); Rev. Rul. 69-156, 1969-1 C.B. 101 (grant of certain rights in patents, while transferor retained right to use such patents failed to qualify as a transfer of property for § 351 purposes because not all substantial rights were granted); Rev. Rul. 71-564, 1971-2 C.B. 179 (grant of exclusive to use a trade secret until it becomes public knowledge qualifies as transfer of property for § 351 purposes). The Court of Federal Claims in E.I. Du Pont de Nemours & Co. v. United States, 471 F.2d 1211 (Cl. Ct. 1973), declined to adopt the Service's position and liberally interpreted "property" for § 351 purposes to mean "a positive business asset" and "something of value" such as a license. Notwithstanding the Claim Court's decision in Du Pont, the Service continues to assert its position in Revenue Ruling 69-156.

²¹ No implication can be drawn from the assumption that the transaction so qualifies.

If Corp Z transferred less than all substantial rights in the patents and know-how subject to the Use Agreement, the Use Agreement would not qualify for § 351 treatment under the Service's published position, but a court could find that the Use Agreement qualifies under § 351 based on the principles of Du Pont. In any event, Corp Z's claimed loss is denied. If less than all substantial rights in the patents and know-how were transferred, the Use Agreement is a licensing transaction, not a sale, and Corp Z's claimed loss is denied consistent with the primary argument discussed above in Law and Analysis Section I. If § 351 is held to apply to such transfers under the principles of Du Pont, Corp Z's claimed loss is still denied both because the Use Agreement is a licensing transaction and because § 351(b)(2) denies recognition of a loss. If, on the other hand, there is a finding that all substantial rights were transferred, the Use Agreement qualifies for § 351 treatment under the Service's published position and should be integrated with the § 351 transfer of property under the Equity Agreement as discussed below. The discussion below (Law and Analysis Section II.A.) assumes that the exchange described in the Use Agreement qualifies under § 351.

A. Applicable Law

(1) Integration

Courts have held that a § 351 transfer to a corporation and a sale of property to such corporation (purportedly separate from the § 351 transaction) should be integrated and treated as a single § 351 transaction where the transfers are part of the same overall plan. See Stanley, Inc. v. Schuster, 295 F. Supp. 812 (S.D. Ohio 1969), aff'd, 421 F.2d 1360 (6th Cir. 1970), cert. denied, 400 U.S. 822 (1970); see e.g. Camp Wolters Enterprises, Inc. v. Commissioner, 230 F.2d 555 (5th Cir. 1956), Burr Oaks Corporation v. Commissioner, 365 F.2d 24 (7th Cir. 1966). Although the relevant case law applies different analyses in reaching this conclusion, the critical factor present in these cases is that the purportedly separate transfers were related.

In Stanley, cash was transferred in exchange for voting stock of a corporation formed for the purpose of subdividing, developing, and selling land. Approximately four years later, land was transferred in exchange for debt. Despite the significant interval of time, the court integrated the two transfers as a single § 351 transaction, as both transfers were part of a single plan for forming and financing the corporation. The court reasoned that the business had not been "fully formed and launched" until the land had been transferred to it since the land was its only asset, and without such asset, the corporation was incapable of doing business.

In D'Angelo Associates, Inc. v. Commissioner, 70 T.C. 121 (1978), a dentist transferred cash in exchange for stock of a newly formed corporation in a § 351 transaction. Nine days later, the dentist purportedly sold a building and equipment to the corporation in exchange for cash (previously contributed by the dentist) and debt. Thereafter, the dentist leased the property from the corporation to operate his dental practice. The Tax

Court held that because the two transactions were consummated pursuant to a plan to transfer business assets from individual to corporate ownership, the transfers were integral parts of a single § 351 transaction. The court noted that any reason for the corporation's existence "would have vanished absent the transfer" of the property and there was no business reason for separating the transfers. Id. at 130-131.

As in Stanley, both the Use Agreement and the Equity Agreement were part of a plan for _____, and therefore, should be treated as components of a single § 351 exchange. Corp Y and Corp Z implemented Project J by entering into the Use Agreement and the Equity Agreement, as well as a Supplemental Agreement. Both the Use Agreement and the Equity Agreement were executed on the same date, by the same representatives from Corp Z and Corp Y, and together carried out what the two companies set to achieve from the outset:

. Clearly, the Use Agreement was an element of an overall plan. The fact that Corp Z negotiated a \$** cap for its liability under both agreements on a collective basis and limited the method of liability payment to its Corp Y stock further proves that Corp Z viewed the two agreements as part of a single transaction.

Like in D'Angelo, any reason for entering into the Equity Agreement (the portion of the transaction Corp Z treated as a § 351 transaction) would have vanished absent the Use Agreement, and as such, the two agreements are in substance integral parts of the same transaction. Corp Y could not have continued without _____, the necessary equipment, . Similarly, Corp Z could not have carried out its plan

Moreover, it is inconceivable that Corp Y's Existing Shareholders would have been willing to commit \$** to acquire the tangible assets _____ unless they were assured that Corp Y would also

Moreover, the terms of the agreements support the finding that the Use Agreement and the Equity Agreement are related, and were part of the same overall transaction. The terminology used in the Equity Agreement is defined in the Use Agreement, and cannot be understood unless one refers to the Use Agreement. Further, certain intangibles subject to the Use Agreement could not be transferred unless the Equity Agreement was consummated. For example, the intangibles Corp Z agreed to license under the Use Agreement included

. To fulfill this obligation, Corp Z must transfer pursuant to the Equity Agreement. Thus, if the transfers contained in the Equity Agreement qualify under § 351, then the transfers contained in the Use Agreement (assuming they otherwise qualify under § 351) are subject to § 351.

(2) Step Transaction

Courts have also integrated purportedly separate transfers into a single § 351 transaction by applying the step transaction doctrine. See Makover v. Commissioner, T.C. Memo 1967-53. Under the step transaction doctrine, “interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.” Commissioner v. Clark, 489 U.S. 726, 738 (1989).

There is no universal test for determining whether the step transaction doctrine applies to a particular situation, but courts have developed three primary tests, Brown v. United States, 782 F.2d 559, 563-564 (6th Cir. 1986): (1) the “interdependence” test, (2) the “end result” test, and (3) the “binding commitment” test.). Of the three tests, courts and the Service have applied the mutual interdependence and the end result tests to determine whether two purportedly separate transfers should be stepped together into a single § 351 transfer. The interdependence test focuses on “whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series,” Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527 (10th Cir. 1991) (citations and quotation marks omitted). Under the “end result” test, “purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.” Associated Wholesale Grocers, Inc., 927 F.2d at 1523.

The IRS national office has applied the step transaction doctrine in determining whether to integrate separate transfers into a single § 351 transaction. The Service has advised that the end result test will apply if, at the beginning of the initial transfer, the transferor intended to enter into the subsequent transaction. Thus, it is the transferor’s actual intent that is relevant in analyzing whether formally separate transfers should be collapsed into a single § 351 transaction.

In Makover, the Tax Court applied the mutual interdependence and end result tests to determine whether a transfer of assets and cash by a partnership to a newly formed corporation in exchange for stock and a demand note should be treated as a single § 351 exchange. The court’s analysis focused on whether the two transfers were part of the overall plan for incorporating the partnership’s business.

(a) The End Result Test

Under the end result test, purportedly separate transactions will be stepped together if the transactions are really component parts of an overall transaction intended at the outset to be effected for the purpose of reaching the ultimate result. Corp Z’s claim that the Use Agreement was an isolated transaction lacks merit. The Year 10 Transaction began with a business decision by Corp Z

In carrying out that business decision, Corp Z first sought . When that pursuit failed to materialize, Corp Z opted for a plan with Corp Y, a plan characterized by Corp Z as . Corp Z Officer 1, in recommending the plan to Corp Z’s upper management for approval, presented the plan as one comprehensive scheme consisting of a license arrangement, an equity transaction,

. The plan described by Corp Z Officer 1 called for Corp Z to (1) license a large pool of intangibles developed by the Corp Z to Corp Y for use in limited fields, (2) contribute certain tangibles that had been developed, used, or obtained by , and (3)

in exchange for (1) future royalty, milestone and upfront fees

, (2) stock, and (3)

. Corp Z referred to this comprehensive scheme as Project J. Thus, the facts demonstrate that from the outset, Corp Z intended to treat the Equity and Use Agreements as two parts of a single transaction, thereby satisfying the end result test.

(b) The Interdependence Test

Under the interdependence test, a series of transactions will be stepped together if the transactions are so interdependent that the legal relationships created by one or more of the transactions would be fruitless without completing the series. As discussed above, Corp Y could not have continued developing the H without the property transferred pursuant to the Equity Agreement (the necessary equipment and).

. Moreover, it is inconceivable that Corp Y’s Existing Shareholders would be willing to commit \$** to acquire the tangible assets

The terms of the Equity Agreement and the Use Agreement also demonstrate the mutual dependence between the licensing arrangement and the equity transaction. First, the Equity Agreement could not be read without referring to the Use Agreement. The Equity Agreement requires Corp Z to contribute the

, and the tangible

embodiments of the “Corp Z H Know-How” and “Licensed IP.” One cannot understand the meanings of these quoted terms by reading the Equity Agreement alone. The only way to understand these terms is by reference to the Definition section in the Use Agreement. Second, neither agreement could be independently performed. For example, the intangibles Corp Z agreed to license under the Use Agreement included the . To fulfill this obligation, Corp Z had to transfer pursuant to the Equity Agreement. Another example is Corp Z’s reversionary right under paragraph ** of the

Use Agreement. Under that paragraph, if Corp Y at any time chooses to advance less than ** items before reaching certain sales milestone, it must return the rest of the items and their related tangible know-how to Corp Z. This reversionary provision would have been meaningless unless Corp Y also received the tangible know-how under the Equity Agreement.

The licensing arrangement was a necessary step to achieve the plan of continuing Corp Z's _____ in Corp Y _____. The equity transaction alone would not have accomplished the plan. The legal relationship created by the Equity Agreement would have been pointless, standing alone, since a roomful of _____ equipment without the _____ would have been meaningless. Similarly, the legal relationship created by the Use Agreement would have been useless by itself, since Corp Y did not have the existing capability to _____.

- (c) The Ninth Circuit opinion in In re Steen v. United States.

In In re Steen v. United States, 509 F.2d 1398 (9th Cir. 1975), the Ninth Circuit integrated two contemporaneously executed agreements in analyzing a stock sale transaction. In that case, the taxpayer reported the cash value of stock sale pursuant to a Stock Purchase Agreement but neglected to report anything pursuant to the contemporaneously executed uranium Mining Agreement. The Ninth Circuit agreed with the taxpayer that the two agreements formed parts of a larger agreement and needed to be read together. The Ninth Circuit observed:

Given the size of the transaction, the related subject matter of the two documents, the fact that they were contemporaneously negotiated, drafted, executed and delivered, and the substantial certainty that neither would have been executed without the other, it is apparent that they integrate a single large transaction.

509 F.2d at 1403.

Here, as in In re Steen, the Equity Agreement and the Use Agreement were contemporaneously executed. The fact that they were the products of a **-long negotiation between Corp Y and Corp Z over a ** dollar deal, and that the Equity Agreement must be read together with the Use Agreement, strongly suggest that both agreements were also negotiated and drafted at the same time. Both agreements covered _____, and neither would have been executed without the other. Therefore, where, as here, two or more written agreements are contemporaneously executed as part of one complete transaction, they must be construed together.

III. Alternatively, even if the Use Agreement is a Stand Alone Sale Agreement, No Loss Can be Recognized in Year 10

The Internal Revenue Code defines "gross income" as "all income from whatever source derived" including "[g]ains derived from dealings in property." I.R.C. § 61(a)(3). The gain from the sale or other disposition of property equals the "amount realized" by the taxpayer in the transaction minus the taxpayer's adjusted basis in the property. I.R.C. § 1001(a). The "amount realized" is "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b).

If the Use Agreement is in fact a contingent payment sale of the technology or patents, gain would generally be reported on the installment method. I.R.C. § 453(a) provides that, except as otherwise provided, income from an installment sale shall be taken into account under the installment method. Section 453(b)(1) defines an installment sale as 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. Section 453(c) defines the installment method as 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) provides that the Secretary of the Treasury shall prescribe regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot readily be ascertained.

Temp. Treas. Reg. § 15a.453-1(c)(1) of the temporary regulations defines the term "contingent payment sale" as a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale or other disposition occurs. The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or fixed payment terms.

Rules are provided for allocating the taxpayer's basis to payments received and to be received in a contingent payment sale. The rules distinguish between contingent payment sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable. 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 whether the payments received under the agreement are in the nature of rent or royalty income. Such are subject to close scrutiny to determine if a sale has occurred. If such an arrangement is is

determined to qualify as a sale, basis shall be recovered over a period of 15 years commencing with the date of sale.

If the taxpayer had in fact sold its patents and elected out of the installment method in a manner provided by Temp. Reg. § 15a.453-1(d)(3), the agreement would most likely be treated as a debt instrument that is a contingent payment debt instrument subject to either Treas. Reg. § 1.483-4 or Treas. Reg. § 1.1275-4(c). Treas. Reg. § 1.1001-1(g)(2)(ii) provides a special rule to determine the amount realized attributable to the debt instrument. If the debt instrument is subject to Reg. § 1.1275-4(c), the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under Reg. § 1.1274-2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If the debt instrument is subject to Reg. § 1.483-4, the amount realized attributable to the debt instrument is the stated principal amount of the debt instrument, reduced by any unstated interest (as determined under I.R.C. § 483), and increased by the fair market value of the contingent payments payable on the debt instrument. Reg. § 1.1001-1(g)(2) does not apply, however, if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable. Reg. § 1.1001-1(g)(2) also does not apply if the income from the exchange is reported under the installment method of § 453.

In this case, however, the taxpayer has suggested that its agreement is a sale that has resulted in a loss. That has yet to be seen. Losses are allowed by I.R.C. § 165(a) if they are not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) provides that to be allowable as a deduction under § 165(a) a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. See also, Reg. § 1.165-1(d)(1). If, however, there is a claim for reimbursement with respect to which there is a reasonable possibility of recovery, no portion of the loss with respect to which reimbursement may be received is sustained until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Reg. § 1.165-1(d)(2)(i). The existence of such a possibility of recovery is a question of fact to be determined upon an examination of all facts and circumstances. The burden of proving that fact is on the taxpayer. Boehm v. Commissioner, 326 U.S. 287 (1945). As in a case of theft, or a claim that stock is worthless, § 165(a) and Reg. § 1.165-1(d)(2), require that the taxpayer must establish that it does not have a reasonable prospect of recovering the amount of the claimed loss. Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, aff'd, 521 F.2d 786 (4th Cir. 1975).

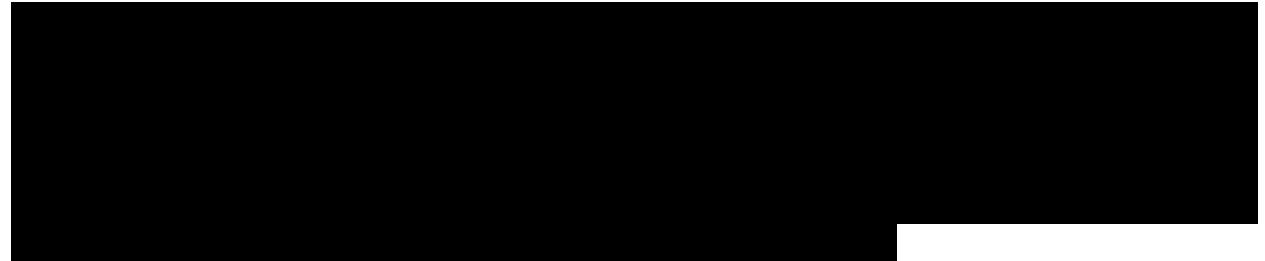
Reg. § 1.165-1(d)(2)(i), requires that the taxpayer prove that it could have been ascertained with reasonable certainty as of the close of the year for which the loss was claimed that the loss would not be recovered. See Jeppsen v. Commissioner, 128 F.3d 1410, 1418 (10th Cir. 1997). Thus, to sustain a loss the taxpayer must include the fair market value the contingent payments in determining the amount realized. The

taxpayer's right to contingent payments will generally preclude a current deduction under § 165 unless the taxpayer can establish that the amount realized, including the fair market value of the contingent payments, is less than the basis of the property sold, or that there is no longer a reasonable prospect of receiving the contingent consideration, for instance, if efforts are abandoned by the purchaser.

Therefore, if it is determined that a sale has occurred, the sale would be treated as a contingent payment sale, since it is our understanding the taxpayer has not elected out of the installment method. See Temp. Reg. § 15A.453-1(d). The taxpayer would apply its basis to the amounts received based on the allocation provided under the applicable subsection of Temp. Reg. § 15A.453-1(c). If subsequent events reveal that the taxpayer no longer has a reasonable prospect of receiving the contingent payments, a loss for the taxpayer's remaining unrecovered basis would be allowed at that time. Though the installment method does not apply to transactions that result in a loss, Rev. Rul. 70-430, 1970-2 C.B. 51, the taxpayer cannot demonstrate that a loss was sustained.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You have informed us that, rather than increasing its claim from \$** to \$** as Corp Z asserted it would do when we began developing the facts, Corp Z has withdrawn its claim. The law fully supported rejecting Corp Z's claim, with the last minute withdrawal of the claim corroboration of the strength of the IRS legal position, albeit the above opinion based on the developed facts was not yet released to Corp Z.



Thus, given Corp Z could resurrect its claim relative to the Use Agreement, or submit a similar claim for any one of multiple other Corp Z licenses, we are issuing the requested advice which was drafted before the claim was withdrawn, at your request. While the withdrawal of the claim suggests that the below addressed potential hazards may be slight, we have left the hazards as drafted (with slight modification) and request that you contact us if this claim is resurrected, or a similar claim submitted, so we can update the hazards based on any revisions to the facts alleged by Corp Z. We may also pursue two additional arguments against Corp Z's potential claim to recharacterize the Use Agreement: (1) Corp Z may be prevented from disavowing ownership of certain assets that basis was allocated to in the Year 12 closing agreement by virtue of that agreement; and (2) Corp Z's claimed recharacterization may be a change in method of

accounting under Cubic Corp. v United States, 34 A.F.T.R.2d (RIA) 5895 (S.D. Cal 1974), aff'd 541 F2d 829 (9th Cir. 1976).

Issue 1

A. Property "Sold"

[REDACTED]

B. Valuation Hazard

[REDACTED]

While Corp Z contends it has no valuations or similar documents, Corp Z's written responses to IDRs (e.g., requesting the subject be discussed and objecting on burden without unequivocal representations of no documents) casts some doubt on the representations. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

C. Extrinsic Evidence [REDACTED]

[REDACTED]

[REDACTED]

We suggest [REDACTED]

[REDACTED]

Finally, we suggest [REDACTED]

[REDACTED]

Issue 2

We opined in issue 1 that the Use Agreement cannot be recharacterized as a sale agreement. However, in issue 2, in order for the license to be considered as a part of a section 351 exchange, there must be a determination that the license indeed amounted to the level of a sale, in light of the Service's existing published guidance.²² It is difficult to imagine under the facts in this case how a court could find that the Use Agreement was a sale agreement based on the overwhelming qualifications to Corp Z's license. Thus, the likelihood for the second issue to arise appears remote.

Nonetheless, if a court finds that the license qualifies as a sale, Corp Z would steadfastly argue, as it has, that the sale was a stand-alone transaction [REDACTED]

[REDACTED]

[REDACTED] This is an inherently factual analysis [REDACTED] Corp Z has an equity interest [REDACTED] in Corp Y. [REDACTED] Therefore, should Corp Z decide to take this claim forward, the revenue agent need to develop additional facts. [REDACTED] After reviewing those records, [REDACTED]

²² See Rev. Rul. 64-56, 1964-1 C.B. 1; Rev. Rul. 69-156, 1969-1 C.B. 101; Rev. Rul. 71-564, 1971-2 C.B. 179 (addressed in Law and Analysis, Section II, above).

Finally, in rendering advice on this issue, we have assumed that the equity transaction under the Equity Agreement qualifies as a section 351 exchange. If the Service later determines otherwise, this issue, of course, is moot.

Issue 3

The primary positions are as stated above; however, as noted above, Reg. § 1.1001-1(g)(2) does not apply if the fair market value of the contingent payments is not reasonably ascertainable, and only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable. We will first argue that the fair market value of the contingent payments is sufficient to provide Corp Z with gain,

If necessary, we will argue that the value is too speculative to be reasonably ascertainable.

Under the traditional open transaction doctrine, if contingent consideration is so speculative that it has no ascertainable fair market value, then the amount realized cannot be calculated, and the sale remains an “open transaction.” McShain v. Commissioner, 71 T.C. 998, 1004 (1979). In an open transaction, the taxpayer allocates payment first to the recovery of its basis and begins to recognize gains only after it has fully recovered its basis. As noted above, if the commitment can be valued, then the amount realized can be calculated, and the sale is a “closed transaction.” Id. In a closed transaction, the taxpayer must recognize the entire amount of the gain and loss on the sale in the year of the sale. I.R.C. § 1001(c). Where any selling price is to be received after the year of sale, the taxpayer, unless electing out, shall report the gain using the installment method. I.R.C. § 453(a). The installment method of reporting applies only where there is a gain; it does not apply when the sale results in a loss. Rev. Rul. 70-430 (loss sustained on an installment sale of business assets is deductible only in the taxable year in which the sale is made and can not be distributed over the years during which the payments of the selling price are received).

The lead case allowing the open transaction method is the Supreme Court's decision in Burnet v. Logan, 283 U.S. 404 (1931). In that case, both the taxpayer and her mother owned stock in a steel company which, in turn, held a minority interest in a mining company. Id. at 409-410. In 1916, Youngstown Sheet & Tube Company purchased all the stock of the steel company in exchange for cash plus 60 cents per ton of iron ore it received from the mining company. Id. at 409-410. There was no requirement, however, that the mining company extract any particular amount of ore. Logan, 283 U.S. at 409. In 1917, the taxpayer's mother died and taxpayer inherited one-half of her mother's right to receive payments from Youngstown, a bequest valued at \$277,165 for estate tax purposes. Logan, 283 U.S. at 410.

The taxpayer reported the sales using the open transaction method, arguing that she was entitled to recover her basis, both in the shares she had originally owned and in the interest she had inherited from her mother, before having to report any capital gain. Logan, 283 U.S. at 410-411. The Commissioner determined a deficiency based on his position that Youngstown's obligation had a fair market value and that "this value should be treated as so much cash and the sale of the stock regarded as a closed transaction with no profit in 1916." Logan, 283 U.S. at 411. The Commissioner also used the value to apportion subsequent annual payments between income and return of basis. Logan, 283 U.S. at 411.

The Supreme Court agreed with the taxpayer, stating that the open transaction method allowed her income tax liability to be "fairly determined without resort to mere estimates, assumptions and speculation." Burnet v. Logan, 283 U.S. at 412-414. The Court observed that the taxpayer received cash and the promise of future payments "wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty." Logan, 283 U.S. at 413. According to the Court, because the promise had "no ascertainable fair market value" and because the taxpayer might never recover her basis "from payments only conditionally promised," the transaction was not a closed one. Id. The Court also dismissed the fact that Youngstown's promise to pay had been valued for purposes of taxpayer's mother's estate tax by stating that "[s]ome valuation - speculative or otherwise - was necessary in order to close the estate." Logan, 283 U.S. at 413.

Since Logan, courts have extended the application of the open transaction doctrine to various transactions in which a taxpayer receives property that has no ascertainable fair market value at the time of receipt, thus requiring the transaction to be held open in order to determine the ultimate tax consequences. In Westover v. Smith, 173 F.2d 90 (9th Cir. 1949), the Ninth Circuit held that an obligation received and collected subsequent to the original sale transaction had no ascertainable fair market value and, thus, required the transaction to be held open until collection of the obligation. In Westover, the taxpayer sold the assets of a corporation in exchange for cash and a royalty contract. Westover, 173 F.2d at 91. After liquidating the corporation the taxpayer reported the gain on the liquidation, including the assignment of the royalty contract which had "very substantial value" but, "owing to future business contingencies," no ascertainable fair market value. Id. Taxpayer later received payments under the royalty contract and treated them as amounts received in the liquidation distribution, taxed as capital gain. The Court upheld the taxpayer's characterization of the payments, stating:

Although there was no ascertainable fair market value at the time of liquidation, we find nothing in the statute requiring the market value to be measured immediately. In such a situation the only practicable and accurate method of measuring the contract's value is through the application of money to such valuation as it is received.

173 F.2d at 92.

The court viewed the contract as part of the liquidation proceeds and, because it could not be valued at the time of liquidation allowing the taxpayer to determine the total gain on liquidation, treated payments under the contract as liquidation proceeds as well.

In In re Steen v. United States, 509 F.2d 1398 (9th Cir. 1975), the Ninth Circuit again applied the open transaction doctrine to a contingent contract obligation. The taxpayer in that case entered into a stock purchase agreement to sell stock for a specified price with a portion to be paid in cash and the remainder in installments. In re Steen, 509 F.2d at 1401. The taxpayer entered into a second contractual agreement whereby the purchaser agreed to reimburse the taxpayer and the other shareholders for potential state tax liabilities. Id. At the time of the sale, a question of Utah state law existed as to whether the state tax on mines was simply a lien or a personal obligation of a mine's owner. Several years later, the California Supreme Court resolved the tax issue resulting in a reimbursement payment to the taxpayer pursuant to the second agreement. The Commissioner argued that the transaction was closed and that the payment received pursuant to the second agreement was, therefore, ordinary income. The Ninth Circuit held that the contingency payment had no ascertainable fair market value because it depended entirely on a favorable judicial decision on a novel question of state law, and therefore the case "appears to present one of those rare and extraordinary situations" where the transaction is not a closed one for tax purposes. In re Steen, 509 F.2d at 1403.

In Likins-Foster Honolulu Corp. v. Commissioner, 840 F.2d 642 (9th Cir. 1988), the court applied the open transaction doctrine to the liquidation of a corporation where, at the time of liquidation, the corporation was engaged in litigation over condemnation proceeds and thus could not compute the total gain on the liquidation. In that case, the taxpayer argued that the transaction was closed and that an award of additional condemnation proceeds pursuant to a jury verdict three years after the liquidation was a separate transaction. The court disagreed, stating:

Taxpayer presents no evidence suggesting that the amount of just compensation, if any, which the jury might have awarded to [the corporation] in the condemnation proceedings was ascertainable prior to the tender of the jury's verdict. To the contrary, the record contains strong evidence that Taxpayer considered the value of the claims unascertainable at the time of the distribution.

840 F.2d at 650.

Thus, in Likins-Foster as in In re Steen, the Ninth Circuit determined that the gain on the original transaction was impossible to determine thereby requiring the transaction to be

held open where the gain on the transaction depended upon an uncertain judicial determination in the future.

In contrast, when the value of a sold item was specified in the sales contract, courts have declined to apply the open transaction doctrine. For example, in Tombari v. Commissioner, 299 F2d 889 (9th Cir. 1962), the Ninth Circuit declined to apply the open transaction doctrine to a taxpayer's receipt of a real estate contract where the fair market value of the contract was stipulated by the taxpayer at the time of receipt. In Tombari, taxpayers sold their business in exchange for cash and a real estate contract. Tombari, 299 F2d at 890. The taxpayers argued that the contract could not be valued because the amount to be collected was not known at the time of receipt. However, the taxpayers stipulated as part of the sales agreement that the contract had a value that constituted a portion of the sales price. The court held that because the fair market value was stipulated for the contract, the original transaction was able to be closed promptly. Tombari, 299 F2d at 893. Subsequent collection under the contract "was as it is ordinarily, a separate and distinct transaction which 'is required to stand on its own feet.'" Tombari v. Commissioner, 299 F2d at 893, quoting Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952).

Thus, we would argue, if necessary,



At the time the Use Agreement was entered into,



[REDACTED]

To make such an estimate requires many critical assumptions – [REDACTED], market response, and industry competition, to name a few. A single change in the assumptions could distort the original estimate by a large scale.

While G was able to prepare a valuation study on Corp Y's obligation, unlike Tombari, that valuation was not specified in the Use Agreement. In fact, G did not prepare the valuation until two years later when Corp Z decided to re-characterize the Use Agreement from a licensing arrangement to a sale. [REDACTED]

[REDACTED] Corp Z claims that there were no appraisals on Corp Y's contingent payment obligation other than G's ** Year 12 study. [REDACTED]

In addition, there are serious problems in G's valuation study. [REDACTED]

[REDACTED] There were hundreds of patents, know-how, and items allegedly transferred to Corp Y. By choosing only four items [REDACTED], and excluding most of the E from the computation, G rendered a valuation that is at best arbitrary. More critically, G's valuation was admittedly predicated upon Corp Z's assumptions as to Corp Y's sales volume, milestone events, and probability of success. These assumptions were nothing but pure speculations projected by a public company on a private company with much less business history [REDACTED]. Any value derived from those assumptions would be as unreliable as the assumptions themselves.

The proper method of reporting in this case (if the Use Agreement is a sale agreement²³ and if recognition is not precluded by § 351) is to treat the re-characterized sale as a contingent payment sale under § 15A.453-1(c). To support this argument the Service may be required to argue that fair market value of the contingent consideration exceeded the taxpayer's basis at the time of the sale, the burden first lying with the taxpayer to prove that it was less. Alternatively, the Service may argue that the fair market value of contingent consideration was not reasonably ascertainable, § 1001-1(g)(2) does not apply, and the transaction is left open and no current loss is allowed by § 165(a) and § 1.165-2(d). Of course, Corp Z would not be required to recognize any gain until the payments from Corp Y exceed its adjusted basis in the sold intangibles. Correspondingly, Corp Z won't be allowed to recognize any loss until its right to further payments is ended either by satisfaction, compromise, or other operation or law.

[REDACTED]

The Service must first argue that the value is reasonably ascertainable, and greater than the taxpayer's basis, and remind that Court that losses that may be compensated for by future payments are generally not allowed.

[REDACTED]

If this case goes to trial,

[REDACTED]

Bernice Patton Testamentary Trust v. United States, 2001 WL 429809 (Fed. Cl.), at 4. The Court of Federal Claims noted in Bernice Patton Testamentary Trust that:

[REDACTED]

Since Burnet v. Logan, however, statutes, regulations and the courts have severely limited the use of the open transaction method. The doctrine now applies only in “rare and extraordinary cases,” and is generally rejected “in favor of the best estimate of fair market value which the circumstances allow.” (Citation Omitted.)

Id., at 4.



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Deputy Area Counsel (Industry Programs)

By: _____

Industry Counsel

By: _____

Attorney

Attachments: none

cc: