Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: January 30, 2012

to: Team Coordinator
(Large Business & International)

from: Associate Area Counsel
(Large Business & International)

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subject: Taxation of ########## Commercialization Agreement

On April 27, 2011 we issued a case specific legal advice memorandum ("April CSLA") responding to your request for assistance relative to the tax treatment of the Device A transaction reported by Corporation A and Subsidiaries ("Corporation A") on its Year 1 tax return. See Tax Analysts, 2011 TNT 104-22, April 27, 2011 (redacted advice on the tax treatment of commercialization agreements).

Thereafter, in reliance on the April CSLA, you issued the Revenue Agent Report for Corporation A's tax year ended Date 41 ("Year 1 RAR"). Corporation A then submitted its Protest in response to the Year 1 RAR.

This advice responds to your request for assistance in responding to the Protest. This advice may not be used or cited as precedent.

LEGEND

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

Corporation I =
Corporation J =
Agreement A =

Agreement B =

Agreement C =

Agreement D =
Agreement E =
Agreement F =
Agreement G =

Agreement H =

Agreement I =
Agreement J =
Agreement K =
Agreement L =

Agreement M =
Agreement N =

Agreement O =

Country A =
Country B =
Country C =
Country D =
Country E =
Country F =
Country G =
Territory A =
Territory B =
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Year 2 =
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Year 10 =

Year 11 =
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Memo A	=
Memo B	=
Memo C	=
Payment(s) A	=
Payment(s) B	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 8	=
Amount 9	=
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Amount 31	=
Amount 32	=
Amount 33	=
Amount 34	=
Amount 35	=
Government	=

Agency A
Industry A =
Industry B =
Industry C =
Device A =
Device B =
Device C =
Product(s) =
Territory A =
Trademarks
Country B =
Trademark A
Country B =
Trademark B
Use A =
Use B =
Use C =

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

ISSUES

1. Whether, for the Year 1 tax year, Corporation A can treat the Device A Commercialization Agreement ("Agreement A") as a sale agreement, not a license, when such assertion directly conflicts with a closing agreement entered for the tax year ended Date 15, as well as with Corporation A's income tax returns for Year 5 and Year 2, SEC filings, and contracts entered after Year 5.

2. Whether Corporation A's agreements are license agreements based on the language within the four corners of the agreement and, if so, whether the Commissioner can hold Corporation A to the form of its agreements.

3. Whether Corporation A retained any substantial rights.

4. Whether tax law has evolved away from patent law so the agreements at issue would be treated as selling the license established under the License Agreement Concerning Device A between Corporation B and Corporation A ("Agreement C") or Corporation A's patents.

5. Whether § 1253 applies and requires the income from the transfer be characterized as ordinary income.

6. Whether, if a sale occurred, Corporation A properly elected and can use the income forecast method to report the gain from such sale.

CONCLUSIONS

1. Pursuant to I.R.C. § 7121(b)(2), the closing agreement cannot be disregarded or modified because it included an express agreement concerning the character of the payment made under Agreement A. Thus, Corporation A cannot change the character of the income from the agreement to capital. Additionally, Corporation A's prior representations constitute very credible evidence of its intent to enter into a licensing agreement with Corporation H (a wholly-owned subsidiary of Corporation J) in Year 5 that Corporation A cannot overcome, particularly when the tax motivations to change the character of the income are so clear.

2. Corporation A's agreements are license agreements because they clearly evidence that Corporation A intended to license its patents and sublicense Agreement C, which negates intent to sell. The agreements are unambiguous and, in form, license agreements. The Commissioner can and should hold Corporation A to the form of its agreements.

3. Corporation A retained substantial rights in its patents and Agreement C. Thus, Corporation A's agreements are licenses in substance, as well as form.

4. The issues being addressed are tax issues; however, tax law and patent law are consistent. For tax purposes, Agreement C cannot be sold without the explicit consent of the patent holder (Corporation B), with patent law in accord. Tax law has not evolved away from applying the Waterman Rule to determine if a patent is merely licensed, with patent law also continuing to apply the Waterman Rule.

5. Section 1253 applies, and the income received is ordinary.

6. Corporation A did not properly elect the income forecast method, and thus, even if a sale occurred, is not entitled to report the gain from such sale using the income forecast method.

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EXECUTIVE SUMMARY

In response to the examination report for the tax year ended Date 41, issued on Date 24 ("Year 1 RAR"), Corporation A filed a Protest contending that Corporation A's license agreements are actually sale agreements, with the income received capital. Characterization of the income as capital is vital to Corporation A, since Corporation A triggered a large capital loss in Year 6 (via), carried the capital loss back to Year 1, and received a tentative refund in the amount of Amount 2 for Year 1 as a result. The Protest further contends that Corporation A elected the income forecast method so the contingent payment sale rules addressed in the Year 1 RAR do not apply.

During the audit of Corporation A's fiscal Date 13 year, Corporation A represented that the Year 5 Agreement A ("Agreement A") was a license, reporting all income therefrom as ordinary. Corporation A signed a closing agreement for the Year 5 year, representing that Agreement A was a license, and obtained income deferral for the Payment B fee received under Agreement A. Another closing agreement, for Year 10, included an explicit agreement that the Payment A payment received under Agreement A was received for the use of intellectual property, and again income deferral was allowed. Corporation A's Year 5 and Year 11 tax returns, as well as its Year 5 and Year 11 financials, reported Agreement A as a license. During the Year 1 , Corporation A – for the first time – asserted that the Agreement B to Agreement A ("Agreement B") sold the subject matter of Agreement A. Corporation A's Year 1 tax return, when filed, reported the alleged sale, with the return internally inconsistent relative to what was sold.[1] During the subsequent audit of the Year 1 return, Corporation A posited different and mutually exclusive theories as to the year of the sale and what was allegedly sold.

In the Protest, Corporation A may concede or abandon some of the positions posited relative to what was allegedly sold, now alleging it sold "a license interest in a patent" without clarifying <u>what</u> interest was "sold." The arguments in the Protest are internally inconsistent relative to what Corporation A contends it sold (*e.g.*, conceding it did not sell patents, then arguing I.R.C. § 1253 does not apply because said section does not apply to patent sales). The Protest asserts that the only rights Corporation A retained were mere security interests.

In actuality, Agreement B accelerated ordinary income already due Corporation A, which does not change the character of the income to capital. As a matter of law, Agreement A and Agreement B are unambiguous license agreements and Corporation A cannot disavow its licenses. Further, Corporation A retained substantial rights, which

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[1]

confirms the agreements are licenses, but that does not make this case just about weighing the significance of retained rights.

FACTS [2]

A. The Amount 2 Tentative Refund for Year 1

To understand the facts and circumstances of this case, it is appropriate to consider the strategic steps Corporation A took to attempt to eliminate any Federal income tax on the substantial income it earned Device A for commercialization in the United States.

Beginning with Corporation A's tax year ended Date 14, Corporation A has

. For the tax years ended Date 14 and Date 15,[3] Corporation A and the Service entered into closing agreements[4] to resolve the tax treatment of payments received from Corporation H under Agreement A.

The Year 1 return was timely filed,

[5]

the Year 1 tax return was audited. During the Year 1 audit, the "bottom line" tax effect to be achieved by securing capital gain treatment became clear.

[2] The facts herein augment, and in some cases emphasize, facts asserted in the Year 1 RAR; as such these facts supplement, but do not replace, those in the RAR.

[3] Corporation A received

[4] These closing agreements are discussed in more detail in Law and Analysis § A.

[5]

1. The Year 6 Capital Loss

On its Year 6 income tax return, Corporation A claimed a capital loss of (Amount 1). The genesis of this capital loss was the deemed liquidation of Corporation E ("Corporation E"), incorporated in Country ##. Some historical background is necessary to illustrate how the capital loss was realized and recognized in Year 6.

2. The Tentative Refund

Corporation A filed its Year 6 corporate income tax return prior to the Date 16 statutory due date in order to claim the (Amount 1) capital loss.[6] Additionally, a Form 1139, Corporation Application for a Tentative Refund, was filed to carry back the Year 6 capital loss to Year 1, to partially offset the "capital gain" reported from the Device A transaction in Year 1. As a result, on or about Date 17, a tentative refund for Year 1 was issued to Corporation A in the amount of Amount 2. Whether the Amount 2 refund

6

was proper depends upon whether the monies received by Corporation A from Corporation H in Year 1 were ordinary income, or entitled to receive capital gain treatment.

B. Contemporaneous Representations

Representations made by Corporation A prior to filing the Protest in response to the examination report for the tax year ended Date 41, issued on Date 24 ("Year 1 RAR"), contradict the current representation that there was a sale by Corporation A to Corporation H pursuant to Agreement A.

Corporation A's conflicting statements made on its tax returns and in its closing agreements are addressed in Law and Analysis § A, below. Corporation A's additional conflicting statements, are addressed in Law & Analysis § B. 3, below, which summarizes Corporation A's contemporaneous internal memorandums, memorialized interviews of Corporation A's executives and subsequently executed agreements with Corporation B, as well as Corporation A's SEC filings, press releases, [7]

C. Facts That May Not Be in Dispute

After careful review of the Protest, and in the interest of narrowing the items in dispute if possible, set forth below are significant facts (both predicate and conclusory) which may not be in dispute between the parties. However, due to ambiguities raised by statements in the Protest that appear to be conflicting, it cannot be asserted with certainty that the parties are in agreement on any of these items. Nevertheless, this exercise should assist in either narrowing the facts which remain in dispute, or alerting Corporation A that it needs to clarify its position in opposition to the facts asserted, and law applied, herein.

1. Items Not Sold: Patents

Corporation A does not, and never did, own Corporation B's patents. Corporation A did not sell Corporation B's patents. Also, Corporation A did not sell its own patents/patent applications related to Device A to Corporation H. This item of apparent agreement is based upon the following statement in the Protest:

> [Exam's] contention plainly fails to appreciate the distinction between **selling a patent - which Corporation A did not do** in

[7] The documents summarized in Law and Analysis § B, below, are addressed in the Year 1 RAR.

> this case – and selling a license interest in a patent – which is precisely what Corporation A did in this case.

Protest, p. 33 (emphasis added).

However, there is some ambiguity because Corporation A also argues, at various points in the Protest, that it sold Corporation B's patents and its own patents to Corporation H. For example, Corporation A asserts "the Corporation A-Corporation H Agreements unequivocally demonstrate Corporation A's intent to sell – and Corporation H's intent to purchase – the patents and know-how to Device A." Protest, p. 30, first full ¶. Accordingly, Corporation A's actual position on whether any patents, either Corporation B's or Corporation A's, were sold needs to be established.

2. Items Not Sold: Know-How

The Protest does not rebut the facts establishing that Corporation A did not own Corporation B's know-how, so it could not sell Corporation B's know-how. Further, the Protest does not address, much less establish, that any know-how was transferred to Corporation H in perpetuity, as required to sell know-how. See Year 1 RAR, p. 28, n.39 and p. 33, n. 42.

Accordingly, Corporation A may agree that know-how was not sold to Corporation H. However, there is again ambiguity because, while not alleging supporting findings of fact that know-how was sold, Corporation A sprinkles conclusions that it sold know-how randomly throughout its arguments. Accordingly, Corporation A's actual position on whether know-how was transferred needs to be established.

3. Items Not Sold: Device A

Corporation A's Protest did not attempt to establish that Corporation A actually obtained all right, title, and interests to Corporation B's Device A (as opposed to having a license to use and sell, but not to make). Thus, the parties are in apparent agreement that Corporation A did not sell Device A, itself, since one cannot sell what one does not own.

4. Corporation A Property Licensed to Corporation B

In Agreement C, as part of the consideration to obtain Agreement C, Corporation A granted Corporation B a worldwide, perpetual exclusive and royalty free license in Corporation A's know-how. Year 1 RAR, p. 4. As part of the consideration, Corporation A also granted Corporation B an option to be the first to acquire any of its improvements.[8] Agreement C, § 2.3.

[8] See Agreement C, § 1.14 (broad definition of "improvements").

Thus, from Year 7 forward, Corporation B owned rights to Corporation A's know-how and Corporation A's improvements relative to Device A.

5. Corp. A Understated the Consideration Received from Corp. H

The Protest failed to include a response to Exam's assertion that the consideration received by Corporation A from Corporation H was understated because the consideration included

). Since Corporation A has not disputed the assertions in the Year 1 RAR that Corporation A understated the amount received by virtue of the Agreement B, Corporation A's actual position on this issue needs to be established.

D. **Device B Development**

In its financial reports for Date 13, the year in which Agreement A was entered, Corporation A described the process necessary to develop Device B as follows:

Device B Development

LAW AND ANALYSIS [9]

A. Corporation A Cannot Rewrite History to Retain the Amount 2 Tentative Refund

In Year 1, Corporation A amended the Year 5 Agreement A with Corporation H, and "

"[10] Instead of receiving sales-based royalties to be paid as the sales were made (Device B or Device C) by Corporation H, Corporation A received a lump-sum payment of Amount 7 in Year 1, and retained contractual royalties (at a reduced rate) for only ## years (through Year 4), with a further reduced royalty rate to be applied thereafter.

Receiving Amount 7 as a lump-sum in Year 1 addressed two of Corporation A's concerns:

(1) Corporation A substantially reduced its risk that the anticipated income stream generated as a result of of Device A would be discontinued[11] ;[12] and

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[9] All of the arguments and all of the positions in the Year 1 RAR are incorporated herein by reference.

[10] Protest, p. 6.

[11] Since Agreement B still required fairly significant royalties (Amount ##% to ##%) for an additional ### years, the risk was not completely eliminated by the lump-sum payment in Year 1.

[12] See Year 1 RAR, p. 15,

(2)

Clearly, there were very good business reasons for Corporation A to "monetize its anticipated proceeds" from the Agreement A with Corporation H.[13] However, the Amount 7 receipt in Year 1 left Corporation A with a tax problem: the royalty income, ordinary income, would be taxed in full in Year 1. To avoid this, Corporation A triggered a large capital loss in Year 6, hoping to use the carryback provisions to eliminate Federal income tax on the income received from monetizing the Device A . The strategy will only work, however, if the monies received from Corporation H in Year 1 can qualify for capital gains treatment. They cannot.

1. The Year of Purported Sale – Year 5 or Year 1 – Is Significant

Corporation A contends that the year in which the purported sale occurred – Year 5 or Year 1 – is not significant because Corporation A sold a capital asset to Corporation H and, therefore, the transaction is entitled to capital gain treatment whether the sale occurred in Year 5, or in Year 1.[14] This contention is wrong and must be rejected. The fact that the majority of the Protest is spent asserting that the sale occurred in Year 5, which argument requires Corporation A to contradict statements made in prior SEC filings and on prior tax returns, as well as in two closing agreements with the Service (as discussed below), shows the insincerity behind Corporation A's contention that the year of sale is irrelevant.

If Agreement A did **not** result in a sale by Corporation A to Corporation H, but only resulted in a sub-license (of Corporation B's license) and a license from Corporation A to Corporation H (as clearly provided in Agreement A), then the income to be paid by Corporation H to Corporation A under Agreement A was for the use of intellectual property and is taxed as ordinary income. If the income received under Agreement A is

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[13] Protest, p. 6, acknowledges that Agreement B was entered into in order to "monetize [Corporation A's] anticipated proceeds," but the parties disagree with the Protest's further characterization that there was a "Year 5 transfer of [Corporation A's] rights in Device A."

[14] The Executive Summary of the Protest, at page 1, asserts:

> Because Corporation A transferred all substantial rights in its interest in Device A in Year 5, Corporation A sold a capital asset in that year. However, only the tax treatment of the proceeds after the Year 1 renegotiation is at issue here. Therefore, regardless of whether Corporation A's sale to Corporation H was completed in Year 5 or Year 1, the conclusion is the same – Corporation A obtained a capital asset from Corporation B, sold it years later, and accordingly is entitled to capital gain treatment on the proceeds it received from Corporation H.

paid for the use of intellectual property, then the income received from Corporation H under Agreement B or, as Corporation A refers to it, pursuant to the "Year 1 renegotiation," retains the same character so would also be taxed as ordinary income.

While Corporation A disclaims that the year of sale is relevant, in fact Corporation A must be successful in its attempt to characterize Agreement A between Corporation A and Corporation H as a sale of a capital asset so as to avoid application of the well-established principle that acceleration of income receipt does not change the character of the income received. This position is fully set out in the Year 1 RAR, at pages 24-28, and will not be restated herein. However, the following observations regarding the Protest are appropriate:

1. Other than the bare assertion that it does not matter if the sale took place in Year 5 or Year 1, nowhere in the Protest does Corporation A refute the Service's argument that the income received in Year 1 must be taxed as ordinary income because it represents a mere acceleration of the ordinary income to be received under the Agreement A;[15] and

2. At certain points in the Protest, Corporation A apparently concedes that the character of income to be received under a contract does not change simply upon acceleration of the receipt of income. For example, in response to Factor Three, Corporation A specifically "agrees that acceleration of receipt of income under a contract does not change the character of the income received."[16]

On page 23 of the Protest, at footnote 101, Corporation A again agrees with the principle that acceleration of the receipt of income does not change the character of the income received.[17] Therefore, it appears as if Corporation A should be willing to

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[15] Specifically, the Protest does not address the Service's discussion of, and reliance upon, the following cases: Commissioner v. P.G. Lake, 356 U.S. 260 (1958); Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (10th Cir. 1962); Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006), *cert. denied*, 549 U.S. 1212 (2007); Hort v. Commissioner, 313 U.S. 28 (1941); Smith v. Commissioner, 48 T.C. 872 (1967), *aff'd in part and rev'd in part on another issue*, 424 F.2d 219 (9th Cir. 1970); Freese v. United States, 455 F.2d 1146 (10th Cir. 1972); Elliott v. United States, 431 F.2d 1149 (10th Cir. 1970); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962); United States v. Midland-Ross Corp., 381 U.S. 54 (1965); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942); Commissioner v. Ferrer, 304 F.2d 125 (2nd Cir. 1962); Womack v. Commissioner, 510 F.3d 1295 (11th Cir. 2007); Prebola v. Commissioner, 482 F.3d 610 (2nd Cir. 2007); Watkins v. Commissioner, 447 F.3d 1269 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Commissioner, 119 T.C. 1 (2002); and United States v. Dresser Industries, 324 F.2d 56 (5th Cir. 1963). The Protest, page 23, footnote 23, at least acknowledges that the RAR cites to Arrowsmith v. Commissioner, 344 U.S. 6 (1952) and Hallcraft Homes, Inc. v. Commissioner, 336 F.2d 701(9th Cir. 1964) to support the rule that the acceleration of the receipt of income does not change the character of the income received.

[16] Protest, p. 31. Note, however, that Corporation A then goes on to argue that the proceeds received in Year 1 were entitled to capital gain treatment because there was a sale under Agreement A.

[17] Again, however, Corporation A asserts that the accelerated income would be capital gain income since "Corporation A transferred all of its substantial rights to Device A to Corporation H" (though not

concede that, if the income to be received pursuant to Agreement A was ordinary income, then the income received under Agreement B was also ordinary income since, as admitted in the Protest, Agreement B was a **"restructuring and acceleration of the proceeds agreed upon in the Year 5 Corporation A-Corporation H Agreement."**[18]

However, it is clear that Corporation A is unwilling to make such a concession. Rather, Corporation A asserts, if Agreement A did not result in a sale, that alternatively the Agreement B Agreement constituted a sale because Corporation A disposed of any previously retained rights that could possibly be viewed as substantial."[19] Apparently, while it is not entirely clear, Corporation A's position is that capital gain treatment is appropriate for any monies received from Corporation H after Agreement B due to the fact that Corporation A disposed of previously retained rights, so that a sale was completed in Year 1. In other words, Corporation A's *alternative* position apparently is that the monies received in Year 1 were not received as an acceleration of the ordinary income to be received under Agreement A, but rather were received merely as compensation for the additional rights transferred to Corporation H under Agreement B.

Such an alternative argument is unsustainable, however, because the position completely disregards the fact that Agreement A already provided, following the commercial launch of Country B Trademark A, for payment of a substantial stream of royalty income to Corporation A. Country B Trademark A was successfully launched right before Agreement B. As admitted in the Protest, the lump-sum paid in Year 1, as well as the shortened sales-royalty stream, were intended as an acceleration of the proceeds previously agreed upon in Agreement A.

[20]

Clearly, Corporation H made the lump-sum payment under Agreement B to compensate Corporation A in lieu of the payments Corporation H was already obligated to make

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specifically clarifying, in that statement, whether the transfer occurred per Agreement A, or only after Agreement B).

[18] Protest, p.23, n.101 (emphasis added).

[19] Protest, p. 23.

[20] See Year 1 RAR, p. 7.

under Agreement A. Further, Corporation A did not forego its vested right to receive those royalty payments under Agreement A for zero consideration. Since the monies received after Agreement B were due to the acceleration of the vested royalty income stream, the monies cannot be taxed as capital gain income from a completed sale of previously retained rights.

2. Contemporaneous Characterization of Agreement A by Corporation A and Corporation H

Corporation A , consistently reported to the SEC, and represented to the public, that Agreement A was a license agreement.[21] Those prior pronouncements by Corporation A constitute superior evidence of the parties' contemporaneous intent when they entered into Agreement A. In fact, those prior pronouncements, particularly in light of the tax motivated reasons to recast Agreement A as a sales agreement, render Corporation A's current position not credible.[22]

3. Closing Agreement for Tax Year Ended Date 15

Corporation A asserts that the Form 906, Closing Agreement on Final Determination Covering Specific Matters, executed in regard to the treatment of the Amount 9 Use A Approval Payment A Payment received by Corporation A in Year 2 ("Year 10 Payment A Closing Agreement"), pursuant to Agreement A, has "no bearing on the tax treatment at issue here."[23] Corporation A is wrong; the existence of said closing agreement is of great consequence to this case. The federal statute governing closing agreements provides that the terms of a closing agreement cannot be annulled, modified, set aside, or disregarded. Corporation A cannot prevail in its argument that Agreement A was a sales agreement because, *inter alia*, Corporation A must persuade the court to disregard a key term of the closing agreement.

The Year 10 Payment A Closing Agreement contains the following agreement (emphasis, and explanatory footnote, added):

> THEREFORE, it is determined and agreed for federal income tax purposes that:

[21] See Law and Analysis, § B.3, below (Corporation A representations).

[22] See Law and Analysis, § B.1, below (further discussion of the intent manifested in the agreements).

[23] Protest, p. 2.

(1) The Use A Approval Payment A Payment[24] received by Taxpayer **was for use of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34**;

(2) Of the Amount 9 Use A Approval Payment A Payment made by Corporation H and received by Taxpayer on Date 42, zero is includible in Taxpayer's gross income for the Tax Year Year 10;

(3) Of the Amount 9 Use A Approval Payment A Payment made by Corporation H and received by Taxpayer on Date 42, Amount 9 is includible in Taxpayer's gross income for the Tax Year Year 1;

(4)

and

(5) This closing agreement shall bind any successor-in-interest to the Taxpayer.

Accordingly, the Year 10 Payment A Closing Agreement did not simply include an agreement as to which tax year the Amount 9 Payment A payment received on Date 42 was to be included in Corporation A's gross income, but also explicitly included an agreement that the payment "was for the **use** of intellectual property and is an advance payment as defined in Rev. Proc. 2004-34."[25] (emphasis added).

The Year 10 Payment A Closing Agreement differs significantly from the closing agreement which resolved the tax treatment of the Amount 10 Payment B received by Corporation A from Corporation H under Agreement A. The Amount 10 Payment B closing agreement ("Year 11 Payment B Closing Agreement") did not include an agreement on the purpose of the payment (*i.e.*, for use of intellectual property), and did not include an agreement on the character of the payment (*i.e.*, an advance payment

[24] The Whereas clauses, which are relevant to interpreting the agreement but are not themselves binding agreements, defined "Use A Approval Payment A Payment" as follows:

[25] The revenue procedure allows, under certain prescribed circumstances, for the limited deferral of advance payments received for "**the use (including by license or lease) of intellectual property**," with intellectual property being defined as including "copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights (**such as franchise rights** and arena naming rights)." Rev. Proc. 2004-34, 2004-1 C.B. 991, §§ 4.01(3)(c), 4.03 (emphasis added).

under Rev. Proc. 2004-34), but only had the following provisions following the "Therefore, it is determined and agreed" clause:

> (1) Of the Amount 11 Device A Payment B paid by Corporation H and received by Taxpayer in Date 1, Year 5, Amount 11 is includible in Taxpayer's gross income for the Tax Year Year 11;
>
> (2)
>
> and
>
> (3) This closing agreement shall bind any successor-in-interest to the Taxpayer."

If the parties' agreement in the Year 10 Payment A Closing Agreement merely stated that Amount 9 was includible in Corporation A's gross income for the tax year Year 1, as was done with the Year 11 Payment B Closing Agreement, the Service would not argue that Corporation A's current position that Agreement A with Corporation H was a sales agreement contradicted the Year 10 Payment A Closing Agreement because, in that case, the only agreement would be as to the year in which the payment was to be included in gross income. However, the Year 10 Payment A Closing Agreement includes an agreement which goes beyond simply stating the year in which the Amount 9 payment will be included in Corporation A's gross income, and includes the parties' agreement as to both the purpose of the payment and the character of the payment received under the Agreement A. Corporation A's current attempt to re-characterize Agreement A with Corporation H as a sales agreement, instead of a license, is completely contrary to the parties' agreement as to both the purpose of the payment and the character of the payment received under Agreement A.

I.R.C. § 7121(b) provides that an agreement reached in a closing agreement authorized by § 7121(a) --

> shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact--
>
> > (1) the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer, employee, or agent of the United States, and
> >
> > (2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

Section 7121(b) defines the statutory requirement of finality of a closing agreement. In sum, § 7121(b)(1) restricts the ability of the government to reopen a case as to matters agreed upon in a closing agreement and § 7121(b)(2) restricts a court from annulling, modifying, setting aside or disregarding a closing agreement.

It cannot be refuted that the terms which follow the "Therefore Clause"[26] in the closing agreement must be treated as terms to which the parties have definitely reached an agreement. In this case, the parties reached an agreement, as stated after the "Therefore Clause," that the "Use A Approval Payment A Payment received by Taxpayer was for use of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34." As such, the court cannot accept any argument that would annul, modify, set aside or disregard the agreement that the Payment A payment, received in Year 2, was received for the **use** of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34.

In the Protest, p. 9, Corporation A asserts that the Service's argument that the Year 10 Payment A Closing Agreement prevents Corporation A from re-characterizing the Agreement A is wrong because the closing agreement "is limited by its terms to the tax treatment of the proceeds received by Corporation A in Year 2." This position is reiterated at pages 21 and 22 of the Protest, wherein Corporation A argues that the closing agreement is only binding as to Year 2, the taxable period stated in the closing agreement. While it is correct that the closing agreement resolves the proper tax treatment of the Year 2 Payment A payment, the closing agreement also determines that the payment was for the **use** of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34. Accordingly, it is impossible for Corporation A to prevail on any argument that the Agreement A constituted a sale agreement without, necessarily, requesting that a court disregard the closing agreement's provision that the Payment A payment made in Year 2 was for the **use** of intellectual property (not sale) and qualified as an advance payment under Rev. Proc. 2004-34.

It should be noted that the principle that a closing agreement binds the parties only to what is specifically agreed to in the closing agreement, which principle Corporation A is trying to use to avoid the preclusive effect of the Year 10 Payment A Closing Agreement to any tax year other than Year 2, had as its genesis early cases considering the reach of agreements contained on Form 866, Closing Agreement as to Final Determination of Tax Liability. Under a Form 866 closing agreement, the total tax liability of a taxpayer for a particular taxable period is determined, and the cases were concerned with

[26] i.e., "THEREFORE, it is determined and agreed for federal income tax purposes that:…." In the Protest, at p. 23, n. 100, Corporation A attempts to dismiss the binding effect of the Year 10 Payment A Closing Agreement by implying that the Service is relying upon only a "whereas" clause in the closing agreement. This is not correct. As shown above, the Service is not relying upon a "whereas" clause, or a premise to the agreement, but is relying upon the parties' agreement that "the Use A Approval Payment A Payment received by Taxpayer was for use of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34."

problems caused by the failure to include in the computation an overlooked factor affecting income or loss. In such cases, since the overlooked factors had not been expressly agreed upon in determining the tax liability for the compromised year, the execution of a closing agreement did not preclude reliance by either party upon such overlooked factors in other taxable years.[27]

In this case, the character of the Amount 9 payment made in Year 2, pursuant to the Agreement A, was not a factor that was "overlooked" when the parties entered into the closing agreement. Rather, the fact that the payment was received for the use of intellectual property was explicitly included as a binding determination in the closing agreement, not simply referred to as a background factor, and the Service is allowed to rely on that agreement as being final and conclusive. S&O Liquidating Partnership v. Commissioner, 291 F.3d 454, 458 (7th Cir. 2002) ("the purpose of the agreement is to terminate and dispose of tax controversies once and for all," so the appeal was moot and the court dismissed it for lack of subject matter jurisdiction).

Corporation A relies upon Zaentz v. Commissioner, 90 T.C. 573 (1988), Quereshi v. Commissioner, 71 T.C.M. (CCH) 2702 (1996), and Chen Wang v. Commissioner, 75 T.C.M. (CCH) 2078 (1998) to support its attempt to avoid the devastating consequences of the Year 10 Payment A Closing Agreement on its current position that the Agreement A was a sales agreement and not a license.

In Zaentz, the Service determined income tax deficiencies for the years 1976 through 1982, asserting several theories to support the deficiency determinations. Among the bases for determination, the Service maintained that certain corporate, partnership and trust entities were shams, so that petitioner Saul Zaentz was the true earner of income generated by the "One Flew Over the Cuckoo's Nest" motion picture, as well as the interest income from loans made by said sham entities. Additionally, the Service determined that, to the extent that income was earned by the trusts, that Mr. Zaentz was to be taxed on the income under the grantor trust provisions. The taxpayer filed a Motion for Partial Summary Judgment, requesting a ruling that, due to closing agreements previously entered into, the Service was barred from raising the sham and grantor trust arguments in the pending litigation.[28] The Tax Court denied the taxpayer's request, determining that none of the closing agreements addressed the income from the Cuckoo's Nest motion picture or the interest income assigned by Mr. Zaentz to entities that the Service was challenging as sham entities in the then pending litigation. Additionally, none of the closing agreements contained an agreement that the entities

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[27] See Phillips v. Commissioner, 8 T.C. 1286 (1947), *aff'd,* 178 F.2d 270 (3d Cir. 1947), *cert. denied,* 339 U.S. 932 (1948); W.C. Mitchell Co. v. Commissioner, 27 B.T.A. 645, 648 (1933); Alabama Mineral Land Co. v. Commissioner, 28 B.T.A. 586, 589 (1933).

[28] One closing agreement resolved a dispute concerning the allocation of profits and losses of a partnership to its partners, and resolved the amount of royalty deductions which said partnership could claim. Two other closing agreements, one with Mr. Zaentz and one with Argosy Venture, a partnership, resolved the excise tax liability under I.R.C. § 1491 for the 1970 sale by petitioner (through his investment company) of stock in another related company to Argosy.

were bona fide entities to be recognized for all federal income tax purposes. Therefore, while the Court recognized that the Service's argument that certain entities were shams to be disregarded for tax purposes, or that certain trusts were grantor trusts, required the Service to take a position contrary to certain positions that were assumed when the basis for settlement set forth in the closing agreements was reached (e.g., that Argosy was a valid partnership and not a sham entity), the Service was not barred from challenging the nature of the entities since there was no binding agreement on the status of the entities or on the specific sources of income at issue in the pending litigation. In other words, it is acceptable for a party to maintain a position that is contrary to an assumption upon which the closing agreement may have been based, so long as the party does not contradict an item which is part of the agreement itself.

In this case, unlike Zaentz, there is an explicit agreement as to the type of income received by Corporation A under Agreement A with Corporation H; payment was for the use of intellectual property and constituted an advance payment as defined under Rev. Proc. 2004-34. This is a binding agreement as to the character of payment made under Agreement A, the specific source of income that is at issue herein. Corporation A's current position, that Agreement A is a sales agreement, is contrary to the explicit terms in the closing agreement and not simply contrary to an implied or assumed basis for the settlement.

Quereshi and Chen Wang, two memorandum opinions of the Tax Court, recite the general principle that closing agreements are only binding as to matters agreed upon for the taxable period stated in the agreement. These cases, however, provide little relief for Corporation A on this issue because, while the parties were not precluded from making certain arguments due to closing agreements pertaining to prior years, the taxpayers were not able to produce evidence sufficient to overcome the statements in the prior closing agreements.

While the court found that the closing agreement in Quereshi did not preclude the taxpayer from claiming certain deductions, credits and losses in 1984, a tax year not specifically included in the closing agreement, the court disallowed all the deductions claimed for that year because the taxpayer failed to produce sufficient evidence to support the claimed deductions, including a failure to produce evidence to refute the agreed item that certain property was placed in service on December 5, 1983.

In Chen Wang, the taxpayer argued that a closing agreement covering specific matters for the 1979 tax year ("1979 closing agreement") prevented the Service from challenging the taxpayer's use of the cost recovery method of accounting in connection with land sales in 1989, 1990 and 1991. The court found that the closing agreement did not preclude the Service from challenging the use of the cost recovery method, but not simply because the closing agreement was for the 1979 tax year while the litigation

concerned the 1989, 1990 and 1991 tax years.[29] Rather, the closing agreement for 1979 was not found to prevent the Service's challenge because the taxpayer was unable to show that the parties had actually reached on agreement on the use of the cost recovery method when they entered into the closing agreement:

> Petitioner's own witnesses at trial were unable to discern the method used for calculating the income in the 1979 closing agreement by merely reviewing the agreement. The words "cost recovery method" are not present in the 1979 closing agreement. Further, not one word of the 1979 closing agreement is devoted to the purportedly agreed upon method for reporting income in future years.
>
> Petitioner and EIC used the installment method to report income in tax returns that were filed after the 1979 closing agreement was executed. This seriously undercuts petitioner's contention that the parties intended that the 1979 closing agreement would require them to use the cost recovery method in future years. *See* Pacific Portland Cement Co. v. Food Mach. & Chem. Corp., 178 F.2d 541, 554 (9th Cir.1949) (when interpreting a contract, a court may look to the parties' actions in ascertaining their intent). Therefore, we find that the 1979 closing agreement does not cover the method for reporting income during the years at issue.

Wang, 75 T.C.M. (CCH) 2087, 1998 WL 144991 (U.S. Tax Ct.) * 8 (1998).

That specific agreed items contained in a closing agreement for prior tax years can have a decisive effect on litigation concerning subsequent tax years, even if the subsequent tax years are not mentioned in the closing agreement, is demonstrated in Nadler v. Commissioner, T.C. Memo. 1992-383, *aff'd. without published opinion* 993 F.2d 1533 (2d Cir. 1993). In Nadler, the taxpayer claimed investment tax credits and distributive losses from his investment in Milton Cable Associates, a partnership. Following audit, the parties executed a Form 906 closing agreement that contained, among other items, the following terms of agreement:

> (1) That the taxpayer is entitled to ordinary deduction from taxable income in the amount of $15,600.00 for the taxable year ended December 31,

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[29] Although the court in Chen Wang stated as a general principle that a "closing agreement is binding only as to matters agreed upon for the taxable period stated in the agreement", the reference cited for support of that proposition was Estate of Magarian v. Commissioner, 97 T.C. 1, 4 (1991). In Estate of Magarian, the taxpayer argued that the Service was precluded from asserting additions to tax and increased interest for 1981 because the parties had previously entered into a closing agreement that resolved the partnership deductions (upon which deductions the additions to tax and increased interest were based) for the 1981 tax year. The Tax Court rejected that argument because the closing agreement did not contain an agreement regarding the additions to tax for 1981. Therefore, the holding in Estate of Magarian was based upon the determination of what was agreed to – and what was not agreed to – in regard to one year, 1981, and was not a determination that an agreed item contained in a closing agreement for one tax year can only be binding as to that same tax year.

> 1977 and an ordinary deduction from taxable income in the amount of $24,400.00 for the taxable year ended December 31, 1978, said deduction being the equal [sic] to the cash paid by the taxpayer.
>
> * * * * * * * * *
>
> (3) That taxpayer has an adjusted basis of zero as of December 31, 1978 for his partnership interest in Milton Cable Associates.

Nadler, 64 T.C.M. (CCH) 70, 1992 WL 156029 (U.S. Tax Ct.) p. 2 (1992).

After entry into the closing agreement, notices of deficiency were issued disallowing losses from Milton Cable Associates claimed by Mr. Nadler for the 1979 and 1980 tax years. The Tax Court found, pursuant to the closing agreement and after noting that a court may not disregard or modify the terms in a closing agreement, absent a showing of fraud, malfeasance, or misrepresentation of a material fact, that the taxpayer had a zero basis in his partnership interest as of December 31, 1978. Accordingly, the taxpayer was required to show that something caused his adjusted basis in the partnership to increase after December 31, 1978, before any of the claimed losses could be allowed. The Tax Court soundly rejected the taxpayer's assertion that a 1977 equipment note gave him a basis in the partnership that was greater than zero:

> Petitioner's interpretation of the effect of the note is inconsistent with the terms of the closing agreement. Petitioner agreed in the closing agreement that he had a zero adjusted basis in his Milton investment as of December 31, 1978. We therefore do not see how an obligation he had incurred in 1977, prior to the execution of the closing agreement, could have entitled him to a positive basis in 1979 and 1980. Whatever petitioner's original basis in the partnership might have been, taking account of the equipment note, the closing agreement wiped out any and all such basis; he cannot now resurrect it. Estate of Johnson v. Commissioner, 88 T.C. 225, 232-233 (1987), *affd. without published opinion* 838 F.2d 1202 (2d Cir. 1987).

Nadler, 64 T.C.M. (CCH) 70, 1992 WL 156029 (U.S. Tax Ct.) p. 3 (1992).

Accordingly, while the prior closing agreement in Nadler "was silent about whether the 1979 and 1980 deductions would be allowed," the court found that the closing agreement was actually devastating to the taxpayer's 1979 and 1980 tax years case because said agreement created the condition (lack of basis) which mandated the disallowance of the deductions claimed for 1979 and 1980.

The Nadler case demonstrates that a court will not be able to disregard or modify the Year 10 Payment A Closing Agreement term which provides that the Payment A payment made under Agreement A was "for the use of intellectual property and is an advance payment as defined in Rev. Proc. 2004-34." Since the closing agreement

includes an express agreement concerning the character of the payment made under Agreement A, said closing agreement eliminates Corporation A's ability to argue that Agreement A was actually a sales agreement.

Additionally, while Corporation A is correct that a taxpayer's representations contained in the "whereas clauses", which serve to give the background information supporting the "determination clauses" of a closing agreement, do not bind a taxpayer, Park v. United States, 992 F.2d 955, 959-960 (9th Cir. 1993), Corporation A underestimates the value of those representations. Here, representations regarding Agreement A made in the two Form 906 Closing Agreements (Year 11 and Year 10) such as "Taxpayer granted Corporation H an exclusive license…to license patents" and "Taxpayer also granted Corporation H an exclusive license to use enumerated trademarks," provide a very difficult background for Corporation A to now characterize the Agreement A as a sale transaction. Those representations are strong evidence of Corporation A's clear understanding that the Agreement A it entered was a license agreement, not a sale agreement. Further, once Corporation A reported both the Amount 10 Payment B payment and the Amount 9 Payment A payment as license payments, Corporation A was bound by the duty of consistency to report consistently in subsequent years.

Finally, Corporation A asserts that it "[m]istakenly" reported the Amount 9 Payment B received in Year 5, as well as the Amount 10 Payment A payment received in Year 2, as payments received by the taxpayer for the use of intellectual property, included as ordinary income and not offset by Corporation A's adjusted tax basis in Agreement C with Corporation B. (Protest, pp.8-9). Further, Corporation A argues that, since the Year 10 Payment A Closing Agreement contained a "misapplication of law," the terms in the closing agreement should not be applied to other years because income tax liability is based upon an annual accounting period and a mistake in a tax determination for a prior year does not bind either party in subsequent periods. (Protest, p. 23, n. 100).

First, the Service rejects the assertion that Corporation A's reporting of the Amount 9 Payment B received in Year 5, and the Amount 10 Payment A payment received in Year 2, was due to a "mistake."

While the Protest indicates that the Service ultimately agreed to deferral of the Amount 10 payment received in Year 2 to Year 1, as an advance payment for the use of property, the Protest omits the fact that Corporation A affirmatively sought the Service's agreement to its deferral of the advance payment. In support of its proposed deferral, Corporation A provided a copy of a "Memo B", dated Date 19, which addressed whether the advance payments to be received under Agreement A were eligible for deferral under Rev. Proc. 2004-34, 2004-1 C.B. 991 ("Memo B"). referred to the following factors to support its determination that **no sale occurred**, so that the Payment As received by Corporation A under the Agreement A were for the **use** of intellectual property:

….Corporation A retained a number of rights with respect to the transferred property. For example, Corporation A

Another example of retained rights is Corporation A's

Collectively, these retained rights appear to be sufficient to conclude that the Corporation H Agreement did not effectuate a sale, but rather a license of the patent and know-how.[30] In addition, based on discussions with

of

Corporation A, the intent was to license the patent and know-how to Corporation H, not to effectuate a sale of such rights. According to

, the Corporation H Agreement is substantially different in terms of the retained rights than previous agreements that Corporation A has entered into where a sale is intended. Further, for financial reporting purposes, Corporation A intends to treat the transfer as a license. …

Because this agreement is less clear [than other agreements reviewed in the Memo B] and thus more risks are attendant, it may be prudent for Corporation A to begin documenting that the license grants to Corporation H is a non-sale in advance of any future IRS scrutiny.

Memo B, pp. ##-## (footnote added).

The position taken on its tax returns for the tax years ended Date 13, Date 14, and Date 15, specifically deferral of the Amount 10 Payment B payment and the Amount 9 Payment A payment received in Year 2, to the following tax years, were not "mistakes" inadvertently made by Corporation A. (Protest, p. 8). Rather, the positions were taken based upon the facts known to Corporation A at the time, and reflected the conclusion that deferral of the ordinary income for one

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[30] also noted these additional retained rights:

year was available for these payments. At the time, Corporation A did not foresee that it might be better off, from a tax perspective, if it treated the payments as sale proceeds rather than as licensing income.

Second, even if the agreement that the "Use A Approval Payment A Payment received by Taxpayer was for use of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34" constituted a mistake, Corporation A is still bound by said agreement since closing agreements cannot be set aside for mistakes of fact or law.[31]

In Estate of Johnson v. Commissioner, 88 T.C. 225 (1987), *aff'd. without published opinion* 838 F.2d 1202 (2d Cir. 1987), the estate was barred from taking a position contrary to the one it took when it entered into a closing agreement to resolve a dispute over whether certain property had to be included in decedent's estate and, if so, at what value. The decedent was a majority shareholder in a corporation that needed bank loans, but the bank would not lend money to the corporation without guarantees from the decedent, secured by life insurance policies payable to the bank (to the extent of the outstanding loans), with the balance, if any, to be paid to decedent's estate. If the bank was paid by receipt of insurance proceeds prior to the loans to the corporation becoming due, said loans were to be assigned to the estate and the corporation was to pay the estate (*i.e.*, the estate had a subordinated participation interest in the bank loan). No value for the life insurance policies or the subordinated participation interest was included in the estate, with the estate taking the position that that it had no right to the life insurance policies since the policies had been assigned as collateral to guarantee a bank loan to a corporation and its subordinated participation interest in the bank loan was valued (by Lehman Brothers) as negligible.

The Service disagreed that the value of the subordinated participation interest in the bank loan was negligible, and asserted that said interest had a value of $2.2 million and should be included in decedent's estate. This estate tax dispute was resolved by entry into a closing agreement that established a value for estate tax purposes, with a correlative unadjusted basis for income tax purposes, of $600,000 for the estate's subordinated participation interest in the bank loan.

The estate eventually received repayment of the loan and was required to report capital gain on the amount received in excess of its $600,000 unadjusted basis. The estate sought to eliminate its income tax liability on said capital gains by claiming that it had constructively received the $4.2 million in life insurance

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[31] Wolverine Petroleum Corp. v. Commissioner, 75 F2d 593, 595 (8th Cir. 1935), *cert. denied*, 295 U.S. 877 (1930); Aetna Life Ins. Co. v. Eaton, 43 F.2d 711, 714 (2d Cir. 1930), *cert. denied*, 282 U.S. 877 (1930); Cramp Shipbuilding Co. v. Commissioner, 14 T.C. 33 (1950), *aff'd. sub nom.* Commissioner v. Harriman Ripley & Co., 202 F.2d 280 (3d Cir. 1953), *acq.* 1954-2 C.B. 4.

proceeds and transferred said proceeds to the bank in exchange for the notes held by the bank, so that the estate had unadjusted basis of $4.2 million and no capital gain when the bank loan was paid in full.

The Tax Court rejected the estate's attempt to avoid income tax on the capital gain, finding that the estate was bound by the terms of the prior closing agreement resolving the estate tax dispute, and refused to allow the estate to advance a contrary or inconsistent position in litigation involving the estate's income tax liability. The Tax Court found that the parties knew all of the relevant information about the transaction at issue when the closing agreement was executed, and that the payment of the insurance proceeds had been at the very heart of the controversy that was settled by the closing agreement. Further, even if the then current position of the estate as to the constructive receipt of the $4.2 million in insurance proceeds (with a correlative $4.2 million in basis) was technically correct, the estate was not allowed to make that argument because it could not contradict the position taken when it entered into the closing agreement. The estate was not permitted to argue that the underlying transaction vis-à-vis the insurance proceeds and its subordinated interest in the bank loans was anything other than what was established in the closing agreement. Estate of Johnson, 88 T.C. at 232-233.

In this case, as in Estate of Johnson, Corporation A is precluded from contradicting the position taken, and agreed to, when the parties entered into the Year 10 Payment A Closing Agreement. Corporation A asserted, and the parties agreed, that "the Use A Approval Payment A Payment received by Taxpayer was for use of intellectual property and is an advance payment as defined under Rev. Proc. 2004-34." The "heart of the controversy" resolved by this closing agreement was the nature of agreement ("transaction") between Corporation A and Corporation H which established the nature of the Payment A payment received under Agreement A. The resolution was that Payment A received was a payment for the use of intellectual property, and was an advance payment as defined in Rev. Proc. 2004-34 (i.e., a royalty payment). Corporation A cannot change its position on the effect of Agreement A to support its attempt to change the character of the income received from Corporation H.

B. The Language and Form of Corporation A's Agreements Preclude Treating the Agreements as Sale Agreements

The Protest argues that, in substance, its agreements are sale agreements. In support of its substance over form argument, Corporation A asserts that, for agreements transferring interests in patents, all that matters is retained rights.

The fact that the agreements transfer interests in patents does not exempt the agreements from well-established contract law and the doctrine that allows the Commissioner to hold a taxpayer to the form of its agreements.

1. Corporation A's Agreements Lack the requisite Intent to Sell

Corporation A agrees that there must be a clear and unmistakable intent to sell at the time of the transfer for either Agreement A or Agreement B to be treated as selling patents or Agreement C.[32] The Year 1 RAR references specific language in the agreements to establish Corporation A lacked a clear and unmistakable intent to sell,[33] while the Protest only contains conclusory statements that the language evidences a contrary intent.[34] The Protest does not reference any specific clauses or words in the agreements that support its position on intent, other than concluding that none of the retained rights were substantial rights. Rather, the Protest relies almost exclusively on abstract discussions of case law, quoting cases, but not the agreements at issue.

a. Corporation A Cannot Ignore the Language of its Own Agreements that Negate Intent to Sell

The Protest's limited discussion of the language in the Agreement A[35] and discussion of the language in the Agreement B[36] focuses primarily on consideration and on rights retained by Corporation A. There can be no doubt that the retention of rights can preclude sale treatment.[37] However, if the language of the agreements at issue fails to evidence a clear and unmistakable intent to sell, then the agreements cannot be treated as sale agreements.

It is the actual words of the agreements that matter for establishing intent. Corporation A's agreements specifically provide that the language in the agreements will be deemed to reflect the intent of the parties.

§ ###:

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[32] "Neither party disputes that for a transfer of an interest in patent rights to be accorded sale treatment for tax purposes, **there must be clear and unmistakable intent to part with all substantial rights, title and interest at the time of the transfer**." Protest, p. 29 (footnote omitted)(emphasis added).

[33] Year 1 RAR, pp. 6-9; 15-18.

[34] See Protest, pp. 20-21("Here, the facts of the Year 5 Corporation A-Corporation H Agreement demonstrate that the intent of the parties was to transact a sale").

[35] Protest, pp. 4-6.

[36] Protest, pp. 6-8.

[37] See Exhibit Two (summarizing the six factors courts consider to determine whether patent rights are licensed or sold, which are applied in the Year 1 RAR, with Factor Six addressing retained rights).

Agreement A, § ### (bold emphasis added).

The language used in the Agreement A reflects intent to license and sublicense, not sell. For example,

Agreement A, ### , page ## (emphasis added).

The grant clause in Agreement A also makes it clear that Agreement A intended to license Corporation A's property and sublicense the rights licensed in Agreement C, not sell, as follows:

License.

Agreement A, §###, pages ### (emphasis added).

The language in other sections of Agreement A also evidences that Corporation A intended to only license and sublicense, not sell. For example, § ###, Sublicensing, states

(emphasis added).

Agreement A specifically confirms that Agreement C between Corporation A and Corporation B is in good standing, not that it was sold to Corporation H. Agreement A, § ###. Agreement A also confirms that each party retains ownership of its own patents. Agreement A, § ###. No language purporting to sell the patents, know-how or Agreement C exists. The plain words throughout Agreement A evidence an intent to license patents and sublicense Agreement C, not sell, as concluded in the Year 1 RAR.

Agreement B is an eleven page document that clearly identifies each and every section of Agreement A that it modified. The modifications make it clear that Corporation A is still a party to Agreement C, Corporation A still retains rights to and under Agreement C, and Corporation A still intends to only sublicense rights in Agreement C.

Agreement B's first modification to Agreement A is to the grant clause of Agreement A.

[38] [39]

In the section of Agreement B addressing commercialization, § ###, the amendment makes it clear that Agreement A, as amended, is still subject to Agreement C.[40] Section ### of Agreement B requires Corporation H to reimburse Corporation A all amounts Corporation A must pay Corporation B under Agreement C, which again shows that Corporation A intended to, and did, keep Agreement C.

Section # of Agreement B is all about managing Agreement C, with:

- § #
- § # making sure that Corporation H will take no action that causes Corporation A to breach Agreement C,[41] and
- § # stating that

[38] Agreement C did not grant Corporation A the right to make. See Year 1 RAR, pp. 2-3 (Corporation A cannot make Corporation B's patented Device A, which is the Device A

[39] Year 1 RAR, p. 31 (Corporation A did not make the right to use exclusive even as to itself).

[40]

[41] Section ## expanded the indemnification provisions of Agreement A "to the extent such act or omission causes or constitutes a breach by Corporation A of Corporation A's obligations under [Agreement C], including without limitation with respect to intellectual property matters." Agreement B, § ##.

These words confirm that the parties intended that Corporation H be a sublicensee, not the new owner of Agreement C. Indeed, the parties would not be worried about Corporation A breaching Agreement C if it had been sold to Corporation H or was being sold to Corporation H. Thus, again, the words of Agreement B negate intent to sell Agreement C.

Even the section of Agreement B (§ ##) makes it clear that Corporation A intends to retain Agreement C, specifically providing that the changes to certain responsibilities of the parties are subject to Corporation A's obligations under Agreement C.

there is a double barreled restriction on Corporation H's ability to dispose of its interests in Agreement A. Section ## precludes Corporation H from assigning its interests in Agreement A to a non-affiliate without Corporation A's prior written consent. However, given § ## is subject to the terms and conditions of Agreement C, even if Corporation A were to consent to an assignment, Corporation H still cannot assign if the assignment is not also approved by Corporation B pursuant to the provisions in Agreement C.

To counter the language of its agreements, during the audit, Corporation A argued the phrase "exclusive license" is synonymous with "sale" in case law so the agreements evidenced intent to sell notwithstanding the language. In response, the Year 1 RAR, pp. 40-41, established that the phrase "exclusive license" is not synonymous with sale, relying on Rail-Trailer Co. v. ACF Indus., 358 F.2d 15, 16-17 (7th Cir. 1966) and Switzer v. Commissioner, 226 F.2d 329, 330 (6th Cir. 1955). Corporation A now agrees that the fact the license is exclusive "does not affect the manifestation of . . . intent."[42]

Despite the fact Corporation A's Agreement A states that Agreement A reflects the entire agreement of the parties,[43] Corporation A seeks to go outside of its agreement to

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[42] Protest, p. 21.

[43] The Agreement A, § ###, states (bold emphasis added):

argue case law to disavow its form and alter the substance. This Corporation A cannot do. Re-interpretation of what constitutes substantial rights, relying on quotes from case law, cannot change the fact that the plain language of Corporation A's agreements fails to evidence a clear and unmistakable intent to sell; rather, the language evidences intent to sublicense and license, which negates intent to sell. Accordingly, the Year 1 RAR should be sustained in full on its position that none of the agreements at issue evidenced the requisite clear and unmistakable intent to sell.

b. Case Law Confirms that the Language Negates the Requisite Intent to Sell

The Year 1 RAR relied on Kronner v. United States, 110 F. Supp. 730, at 734 (Ct. Cl. 1953) (" the best evidence of this intention is the very words used in the contract."); Commissioner v. Hopkinson, 126 F.2d 406, 410 (2d Cir. 1942), *acq*. 1962-2 C.B. 4 ("Their intention, as shown by their language in the contract, was to have the 'seller' sell and the 'purchaser' buy the property."); Commissioner v. Celanese Corp., 140 F.2d 339, 341 (D.C. Cir. 1944) (the intent to sell was confirmed by "unmistakable language" in the agreement.). All three cases relied on the terms used in the agreement to establish intent, and all three were cited with approval by Congress. S. Rep. No. 83-1622, at 422 (1954) as reprinted in 1954 U.S.C.C.A.N. 4621 at 5082. See also Switzer v. Commissioner, 226 F.2d 329, 330 (6th Cir. 1955) **("[A license] can not be held the equivalent of an assignment where the document itself** and the total factual complex surrounding the transaction **negatives such . . . .**")(emphasis added).

The requirement that an agreement must evidence a clear and unmistakable intent to sell in order to be a sale agreement is a basic principle of contract law. See Richard A. Lord, Williston on Contracts § 32:1 (4th ed., updated May 2011)("**The first rule of contract interpretation is to give effect to the intent of the parties; however, the words utilized in the contract are the best resources for ascertaining intent** and assigning meaning with fairness and accuracy.")(citations omitted, emphasis added); Id. at § 32:2 ("**The parties' intentions are, first and foremost, determined by the language used in their agreement**. . . . ")(footnotes omitted, emphasis added).

Agreement A provides that law applies to interpret the words of the agreement, to the extent that interpretation is needed.[44] law follows the rule

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The other named documents were addressed in the Year 1 RAR, and all confirm that only a license and sublicense was intended, not a sale.

[44] Agreement A, § ## (bold added):

Agreement B did not modify the selection of law in Agreement A, so

that the words of the agreement establish the intent.

(citations omitted, emphasis added).

(emphasis added, citations omitted).

It is well established that principles of contract construction, specifically including the requirement that the intent of the parties as expressed in the contract must be given effect, are relied upon for agreements transferring interests in patents. See Hooker Chemicals and Plastic Corporation v. United States, 591 F.2d 652, 658 (Ct. Cl. 1979)("**The cardinal rule in the interpretation of contracts** is to ascertain the mutual intention of the parties and then give effect to that intention, so long as it is consistent with legal principles**.**").

While the Protest, p. 25, n. 107, relies on Lamar v. Granger, 99 F. Supp. 17 (W.D. Pa. 1951) to support the proposition that a later "grant back" of a right to use a patent does

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not negate a prior sale,[45] the cited case also confirms that the intent must be established from the words of the agreements, as follows:

> **Where the language of a contract is plain and unambiguous**, **the court** will not resort to construction but **will enforce the contract according to its terms**.
>
> Where the rights of respective parties are dependent upon a contract, unless that instrument is ambiguous, **the intention of the parties must be determined by the words of the contract**, unaided by oral testimony.

Lamar, 99 F. Supp. at 35 (citations omitted)(emphasis added).

The Tax Court concurs that if an agreement contains a "negative" intent to sell it cannot be treated as a sale agreement, stating:

> **An instrument can not be construed as an assignment of patents where it expressly negatives the transfer of legal title.** An assignment of an interest in an invention is a contract and, like all contracts, *is to be construed so as to carry out the intention of the parties*.

Federal Laboratories, Inc. v. Commissioner, 8 T.C. 1150, 1156-57 (1947) (citation omitted)(bold and underlining emphasis added).

Federal Laboratories found the agreement at issue was intended to be a mere license, not a sale agreement, since the agreement stated it was a license and the ownership of the patents was expressly retained by the patentee. See United States Mineral Products Co. v. Commissioner, 52 T.C. 177, 195 (1969), *acq.*, 1969-2 C.B. XXIII, 1969 WL 99658 (citing Federal Laboratories with approval.)

In Corporation A's case, neither Agreement A nor Agreement B is titled a license (they are titled commercialization agreements); however, both agreements use "terms of art" such as "license", and "sublicense" throughout the agreements, evidencing intent to license, which negates intent to sell. The agreements expressly provide that ownership of the patents will be retained by the patentee. Agreement A, Article ##, Patents, § ##.[46]

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[45] In this case, there is no sale, so there is no sale and license back.

[46] Agreement B did not revoke § ## of Agreement A relative to each party retaining ownership of their own inventions,

To ignore that the words agreed to by Corporation A and Corporation H expressing the intent that Corporation A's rights in the Agreement C be sublicensed, not sold, would be clear error.[47]

To the extent that Corporation A argues that intent matters only with respect to substantial rights,[48] none of these cases, law, limits the requisite intent to sell to substantial rights. Rather, the cases cited herein and in the Year 1 RAR establish the agreement must evidence intent to sell the asset being transferred. As the words of its agreements establish, Corporation A just did not intend to sell either patents or Agreement C.

The Protest argues that the Year 1 RAR should not have cited McDermott v. Commissioner, 41 T.C. 50 (1963), a case in which the taxpayer and his wife claimed that they sold their patents to their wholly-owned corporation, to support the proposition that there must be a clear and unmistakable intention on the part of the transferor to part with all right, title and interest in the property at the time of the transfer, because the agreement at issue in McDermott was ambiguous and Corporation A retained different rights than in that case. Protest, p. 29-30. The fact that Corporation A's agreements are unambiguous just makes Exam's position stronger; it does not make McDermott inapplicable.

The agreements at issue cannot be recharacterized as sale agreements because Corporation A lacked the clear and unmistakable intent at the time of the transaction to sell patents or to sell Agreement C, in full or part. Accordingly, the Year 1 RAR conclusion that Corporation A cannot be treated as selling either Corporation A's patents or Agreement C because Corporation A lacked the requisite intent to sell should be sustained.

2. The Agreements Are, in Form, Licenses

Agreement B § ##.

[47] See Metropolitan Life Insurance Co. v. RJR Nabisco, 906 F.2d 884, 889 (2d Cir. 1990)("The parties' rights under an unambiguous contract should be fathomed from the terms expressed in the instrument itself rather than from extrinsic evidence . . .").

[48] See Protest p. 29 (inserting the modifier "substantial" before the word "rights" when conceding there must be a clear and unmistakable intent to sell.)

The details and specificity of Agreement A evinces that it was meticulously drafted with words of art by knowledgeable persons. In unequivocal terms, Agreement A repeatedly emphasized that rights which were the subject of the agreement were only being sublicensed and licensed, carefully limiting the licensed rights to commercialization in the Territory. Looking at Agreement A, there is no doubt, from the plain and unambiguous language within the four corners of the document, that Agreement A is, in form, a mere license.

Agreement A states that Corporation A is granting a license and sublicense (the grant provision is quoted above.) The plain language of Agreement A has multiple, additional and extensive limits on the license, such as making the license subject to Agreement C.[49]

The plain language of the Agreement B also unequivocally and unambiguously evidences it, too, is a license.[50]

As stated by the Fourth Circuit in Redler Conveyor Co. v. Commissioner, 303 F.2d 567 (1st Cir. 1962):[51]

> **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 were intended to mean what they say**. **We can hardly assume that their use was inadvertent or the product of bumbling draftsmanship**.

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

Corporation A concurs its agreements are, in form, licenses;[52] but, nevertheless relies repeatedly on three cases to argue its agreements can be construed to be sale

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49 See Law and Analysis, § B.1.a, above (quoting additional language from Agreement A).

50 See Year 1 RAR, pp. 15-18, 31, 42-45 (addressing the plain language of Agreement B that clearly evidences it is a license). See also Law and Analysis, § B.1.a, above (quoting language from Agreement B).

51 Redler Conveyor Co. was relied upon in the Year 1 RAR, but the Protest was silent on Redler Conveyor Co.

52 See Protest, p. 9 ("the agreement with Corporation H was described as a **license in form**.")(emphasis added); Protest, p.1 ("long established federal income tax Law requires taxpayers to treat the divestiture of all substantial rights and intellectual property as a sale, even if the agreement for that divestiture is described as a **license in form**.")(emphasis added); Protest, p. 19 ("Thus, the fact that the Year 5 Corporation A-Corporation H Agreement refers to the transfer as 'an exclusive license and sublicense'

agreements.[53] Vision Information Services, LLC v. Commissioner, 419 F.3d 554, (6th Cir. 2005), distinguishes the three cases as follows:

> In support of its argument, the taxpayer cites several cases from the United States Claims Court which held that "the nomenclature and labels employed by the parties, however, are not decisive; the substance of the transaction governs whether it is a sale or a license." Liquid Paper Corp. v. United States, 2 Cl. Ct. 284, 290 (Cl. Ct. 1983); see also Hooker Chems. & Plastics Corp. v. United States, 219 Ct. Cl. 161, 591 F.2d 652, 658 (Ct. Cl. 1979); Bell Intercont'l Corp. v. United States, 381 F.2d 1004, 1011, 180 Ct. Cl. 1071 (1967). **The taxpayer's reliance on these cases is misplaced however**.
>
> **All three of these cases dealt with the 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 thereunder royalties." Redler Conveyor Co. v. Comm'r, 20 T.C.M. (CCH) 371 (T.C. 1961) [1961 Tax Ct. Memo LEXIS 266, at *19], aff'd 303 F.2d 567 (1st Cir. 1962). By contrast, the issue in this case is not whether the license to use the Vision Software was so broad as to constitute a sale of the Vision Software, but rather whether the plain language of the Vision Agreement detailing the Vision Software License instead should be read as a sale of the direct-to-retail trade secret. **None of these cases support the taxpayer's argument** that language indicating the license of one product actually reveals the sale of another one.

419 F.3d at 560, n.1 (emphasis added).

None of the grant clauses in Corporation A's agreements are broad; all grant clauses are narrow and limited to licensing and sublicensing. So, there is no reason (and no right given the plain language of the agreements) to resort to case law in an attempt to recharacterize the license as a sale.

In Corporation A's agreements, the parties selected law as the applicable jurisdiction if there is a dispute as to whether the agreement is ambiguous.[54]

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does not provide any indication as to whether the agreement results in a sale or license for federal income tax purposes.")(footnote omitted).

[53] The case of Liquid Paper Corp. v. United States, 2 Cl. Ct. 284 (Cl. Ct. 1983) is addressed at length in Law and Analysis, § D, below. The two other cases, Bell Intercont'l Corp. v. United States, 381 F.2d 1004, 180 Ct. Cl. 1071 (Cl. Ct. 1983) and Hooker Chems. & Plastic Corp. v. United States, 219 Ct. Cl. 161, 591 F.2d 652 (Cl. Ct. 1979) were addressed at length in the Year 1 RAR, pp. 45-48, with the Protest not refuting the case analysis in the Year 1 RAR. In addition, all three cases are further distinguished in Law and Analysis, § C, below.

[54] Agreement A, § ##.

(citation omitted)(emphasis added).

Corporation A and Corporation H made it clear that the Agreement A was their entire agreement and it could only be modified in writing. Agreement A, § ## (entire agreement); § ## (amendment and modification). Thus, Agreement A expresses the parties' entire understanding - a license agreement.

Accordingly, Agreement A and Agreement B are, in form, licenses. This conclusion is drawn, not just from the use of the words "license" and "sublicense" (although relevant); but, from the fact that the documents demonstrate use of carefully chosen words intended to limit Corporation H to licenses and sublicenses, with the grant clause narrow and limited to a license for commercialization.

Corporation A also attempts to revise specific provisions of its agreements. For example, Corporation A asserts the only consideration Corporation A was to receive after Agreement B was the cash paid in the first three years. The assertion is wrong. Corporation A receives, every year,

[55]

Thus, if the agreements could be treated as sale agreements, Corporation A has significantly understated the amount realized, and understated the term of the agreement.[56] Corporation A would need to take into income

[57]

[55] See Year 1 RAR, pp. 59-60 (amount realized);

[56] The agreement continues "until

Agreement A, § ##. Agreement B did not modify the term.

[57] Id. See Year 1 RAR, § D and Law and Analysis, § F, below (proper application of the installment sale method).

3. Extrinsic Facts Confirm the Agreements are Licenses

If courts were to resort to looking at extrinsic facts to confirm the agreements are licenses, the extrinsic facts confirm that the agreements are licenses.

a. Corporation A's Memo A

Corporation A's own Memo A,

Memo A, p. ## (emphasis added).

The summary within Memo A said nothing about selling Agreement C, rather it stated:

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-
-

Memo A, p. ## (emphasis added).

In addition, Corporation A Memo A, p.## (emphasis added).

Memo A discusses, at length, [58]

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[58]

Given the

there should be a trail of high-level executive and board approval

No such trail exists.

b. Memo B[59]

Memo B, written just months after Agreement A was executed, confirms Agreement A is not a sale agreement. interviewed Corporation A's own management and stated:

- "[B]ased on discussions with

  of Corporation A, **the intent was to license** the patent and know-how to Corporation H, **not to effectuate a sale of such rights**."[60]

- "According to , **the [Year 5] Agreement is substantially different in terms of the retained rights than previous agreements that Corporation A has entered into where the sale is intended**."[61]

This is strong evidence, close in time to Agreement A, that the agreement was, indeed, a license agreement.

c. Year 2 Closing Agreements

In its Year 11 and Year 10 Closing Agreements with the IRS, prior to Agreement B, Corporation A represented its Agreement A is a license agreement, *i.e.*, granting the right to use, not sell. This is even stronger evidence that the agreement was, indeed, a license agreement.[62]

d. Year 1 Memo C[63]

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[59] The Memorandum is to "

" (hereinafter "Memo B"). A copy of this memorandum was provided to Exam for reliance in considering the tax reporting for Corporation A's Year 5 tax return.

[60] Memo B, p. ## (emphasis added).

[61] Id.

[62] The Year 2 Closing Agreement was addressed in the Year 1 RAR and in Law and Analysis, § A, above.

[63] This Corporation A in-house memorandum is dated Date 21

and is labeled . The subject of the memorandum is "Recognition of revenues associated with the outlicensing of Device A - Revised based on [date] Amendment to the original agreement."

Corporation A's Memo C confirms that Corporation A intended to license, not sell, its rights in the Agreement A. Memo C stated:

> *Corporation A has* ***granted to Corporation H certain licenses and sublicenses*** *relating to Device A,* ***licenses to*** *Corporation A Know-How and Licensed Patents and* ***sublicenses under*** *the Corporation B Agreement to Licensed Patents and Corporation B Know-How.*

Memo C, p. 6 (bold emhasis added).

Throughout Memo C, Corporation A continued to refer to Agreement A as a license and/or a sublicense. For example, Corporation A stated that "[i]n ### Year 5, Corporation A entered into an agreement with Corporation H . . . regarding the **outlicensing of Device A**." Memo C, p. 2 (emphasis added).

Corporation A represents that Memo C was never finalized, and that no subsequent drafts exist. However, the length and breadth of the memorandum, with numerous details, provide compelling evidence of Corporation A's contemporaneous view of the meaning of its own agreements.

e. Year 1 Audit Representations to the IRS

Corporation A confirmed to the IRS that Agreement A merely licensed rights. In the response to IDR No. ## that Corporation A sent to the IRS, Corporation A states that the rights transferred are licensed, not sold, to Corporation H, as follows: "**Intellectual property in the form of patents ('Patented IP') was licensed to Corporation H. . . .** "[64]

f. Year 6 Agreement N to Agreement C

After Agreement B was executed, in the document titled " " between Corporation A and Corporation B dated as of Date 2 ("Agreement N to Agreement C") Corporation B and Corporation A confirmed that Agreement A and Agreement B[65] were licenses.

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[64] Response to Response to IDR No. ###, p. 1 (emphasis added). Corporation A's response to IDR No. ### was e-mailed to the IRS by , but titled "Proposed Response to SAIN Number 410." Corporation A never withdrew or finalized the IDR response.

[65] Agreement N to Agreement C specifically references Agreement A, but does not contain a reference to, or even acknowledgment of, Agreement B.

- "

  "[66]

- Corporation H was referred to as **Corporation A's sub-licensee** throughout Agreement N to Agreement C. See, e.g., p. #, ¶ #,

g. Year 6 Amendment to Agreement C Re:

In the document titled " " entered into as of Date 4 between Corporation A and Corporation B to amend Agreement C relative to certain aspects concerning the ("Date 4 Amendment Re: "), Corporation A and Corporation B represented, *inter alia*:

- "
  "[67]

- "
  "[68]

Corporation B and Corporation A would not have represented that " " if Corporation A had previously sold Agreement C to Corporation H, in full or part. If Corporation H was the owner of Agreement C in full or part, Corporation H would have been a party to the Date 4 Amendment Re: .

In the Date 4 Amendment Re: , Corporation B imposed additional personal obligations on Corporation A as follows:

Corporation A shall

[66] Agreement N to Agreement C, p. #, ### (bold emphasis added).

[67] Date 4 Amendment Re: , ### , p. #.

[68] Date 4 Amendment Re: , ### p. #.

Date 4 Amendment Re: , p. # ¶ #.

Corporation B would not be amending Agreement C to expand Corporation A's personal obligations if Agreement C had been sold to Corporation H.

h. Press Announcements

In its press announcements

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Corporation A represents that Agreement A is a commercialization agreement, with Corporation A retaining its rights in Device A.

- (emphasis added).[69] did not announce Corporation A sold its rights to Corporation H. Indeed, ,[70] saying nothing about purchasing all Corporation A's rights.
- [71] [72]
- [73]

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[69] ########,

Id.

[70] Id.

[71]

[72] Id.

[73]

[74]

i. SEC Documents

Corporation A's filings with the SEC represent that Agreement A is a license.

i. Year 5 and Year 2 Filings

In its for the period ended Date 45, Corporation A reported it was entering into a license with Corporation H to commercialize

The consideration received from Corporation H would Corporation A, Inc., at p. ## (Date 10)(emphasis added). The same summary was repeated in Corporation A's filed for the fiscal year ended Date 13.[75]

In its annual report for year ended Date 13, described Agreement A with Corporation A as

(Date 28)(emphasis added).

74

75 Corporation A's Form

Corporation A's Annual Report for the period ended Date 14, explained that

Corporation A, Inc., at p. ##
(Date 25)(emphasis added

Corporation A, Inc. at p. ## (Date
25)(emphasis added).

ii. Year 1 Filings

On its
Corporation A represented there was a sale of rights to Corporation H, with the sale
occurring in Year 1
[76] The
document, however, did not disclose what rights were sold, and did not state that
Agreement C was sold.[77]

As established in the Year 1 RAR, neither patents nor Agreement C was sold. This is
confirmed by

Read together. Corporation A's SEC reporting

establish that the rights which Corporation A asserts it sold are, at most, rights to
commercialize Country B Trademark A

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77

The right to commercialize is a franchise, with the income ordinary as stated in the Year 1 RAR and addressed further in Law and Analysis, § E, below.

j. Summary of Extrinsic Facts

The extrinsic evidence confirms that, even after Agreement B, the ownership status remains unchanged in that:

- Corporation B continues to own Device A, and Corporation B continues to own its patents, know-how and its other intellectual and intangible property the subject of Agreement C;
- Corporation A continues to be Corporation B's licensee, and Corporation A continues to own its intellectual property the subject of Agreement A;
- Corporation H continues to be Corporation A's sublicensee with respect to Agreement C; and
- Corporation H continues to be Corporation A's licensee with respect to Corporation A's intellectual property relative to Device A.

4. The Commissioner Can and Should Hold Corporation A to the Form of its Agreements

As stated above, the Protest concurs that the agreements at issue are, in form, license agreements.[78] However, Corporation A denies that the Commissioner can hold a taxpayer to the form of its agreement if the agreement is one that transfers an interest in a patent, be it a patent or a license to use a patent.[79]

The Commissioner can hold taxpayers to the form of their unambiguous agreements. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) ("This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the

[78] See Protest, page 9 ("…even though the agreement with Corporation H was described as **a license in form.**")(emphasis added).

[79] See Protest, page 1 ("[F]ederal income tax law requires taxpayers to treat the divestiture of all substantial rights in intellectual property as a sale, **even if** the agreement for that divestiture is described as a **license in form**.")(emphasis added).

benefit of some other route he might have chosen to follow but did not.")(citations omitted).

National Alfalfa was cited in the Year 1 RAR, p. 42, for this proposition. The Protest is totally silent with respect to National Alfalfa. No case is cited in the Protest that holds the principles of National Alfalfa do not apply if the agreement relates to interests in patents.

Yet, Corporation A maintains that it can disregard its choice to enter into a license by looking at the rights retained, Protest, pp. 19-21, but only string cites cases in the footnotes to support this position (Protest p. 19, n. 82 and n. 83). However, the cited cases just do not establish that agreements licensing interests in patents are exempt from the principles articulated by National Alfalfa.

The first case cited in footnote 82 is Waterman v. Mackenzie, 138 U.S. 252 (1891). Waterman says nothing that even implies a sophisticated taxpayer can enter into a license, hold out to the entire world the agreement is a license; but then treat the license as a sale for tax purposes. Moreover, Waterman was addressing a purported sale agreement, finding that patent law precluded treating the agreement as assigning the patent, a proposition incorporated into Factor Five in the Year 1 RAR.[80]

Corporation A also relies on two cases that form the foundation of its case, Merck & Co. v. Smith, 261 F.2d 162 (3d Cir. 1958) and E.I. du Pont de Nemours and Co. v. U.S., 432 F.2d 1052 (3d Cir. 1970).[81] Neither of these two cases, nor the other cases cited in the footnotes, say that the principles of National Alfalfa do not apply to agreements transferring interests in patents. (Merck and E. I. DuPont are further addressed in the Year 1 RAR and in Law and Analysis, § D, below.)

The Protest relies on Liquid Paper Corp. v. United States, 2 Cl. Ct. 284 (1983), a case distinguished in Law and Analysis, §§ C and D, below. The Protest also relies on Robishaw v. United States, 616 F.2d 507 (Ct. Cl. 1980); Fawick v. Commissioner, 436 F.2d 655 (6th Cir. 1971) *non-acq*. 1978 2 C.B. 3 and Philbrick v. Commissioner, 27 T.C. 346 (1956), *acq*. 1958-2 C.B. 7. Fawick was addressed in the Year 1 RAR, p. 37, and does not support disregarding the principles in National Alfalfa when an interest in a patent is the subject of the license agreement. Robishaw primarily addresses I.R.C. § 1239 and focused on expert reports relative to value of stock. Philbrick addresses the history of § 1235 and applied said law to an individual. See Law and Analysis, § D, below (addressing Corporation A's reliance on § 1235). None of these cases help

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[80] See Exhibit Two, below (summarizing the six factor analysis applied in the Year 1 RAR, with Factor Five applying the finding of Waterman that an agreement that purports to be a sale agreement cannot be treated as a sale agreement if a mere license).

[81] See, for example, Protest p. 19, nn. 82, 83; Protest p.14, nn. 58, 59; Protest p. 15, nn. 63, 64; Protest, p. 20, n. 84; and Protest p. 31, n. 132 (relying on Merck and/or E.I. du Pont).

Corporation A avoid the fact that Corporation A chose to enter into licenses and sublicenses and can be held to its choice under the principles in National Alfalfa.

In general, the substance rather than the form of a transaction governs for federal income tax purposes.[82] Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Thus, the **Commissioner** has been allowed to discount the form of a transaction, and determine the tax consequences based on its substance. See Gregory v. Helvering; Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir.), *cert. denied*, 454 U.S. 868 (1981); Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232.

However, the Supreme Court has also long recognized that a taxpayer, although free to structure his transaction as he chooses, "once having done so, he must accept the consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted)(emphasis added). Taxpayers have "less freedom than the Commissioner to ignore the transactional form that [they have] adopted", and are ordinarily bound by the tax consequences that flow therefrom. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986), *acq*. 1990-2 C.B. 1. See also, Nestle Holdings, Inc. v. Commissioner, 152 F.3d 83, 87 (2d Cir. 1998); Spector v. Commissioner, 641 F.2d at 381; Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. 590, 601-603 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); Little v. Commissioner, T.C. Memo. 1993-281, 1993 Tax. Ct. Memo LEXIS 284 at * 33 - *34, *aff'd,* 106 F.3d 1445 (9th Cir. 1997). This rule seeks to avoid the uncertainty that would result from allowing the taxability of a transaction to depend on whether an alternative form exists under which more favorable tax consequences would result. National Alfalfa, 417 U.S. at 149; Boulware v United States, 552 U.S. 421, 430, n. 7 (2008); Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960).

The case law recognizes that taxpayers are advantaged by having both the power to structure transactions in any form they choose and the access to the facts that reflect the underlying substance. In contrast, the Commissioner is disadvantaged because he does not have direct access to the facts underlying a particular transaction. Hence, the Commissioner must be allowed to rely on representations made by taxpayers, such as those in the Closing Agreement,[83] and must be allowed to evaluate the resulting tax consequences based on such representations. This reliance is particularly appropriate

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[82] Substance over form was one of the tax doctrines specifically referenced under Factor Three of the six factor analysis applied in the Year 1 RAR, however it was not applied in the Year 1 RAR because the substance is the same of the form, a license. See Year 1 RAR and Law and Analysis, § C, below (Corporation A retained substantial rights in patents and Agreement C).

[83] See Year 1 RAR and Law and Analysis, § A, above (further addressing the Year 10 Closing Agreement).

in the context of a cross border transaction, such as the present case,[84] where documents, information and witnesses are not readily available to the Commissioner.

"The Commissioner is justified in determining the tax effect of transactions on the basis in which taxpayers have molded them . . . ." Television Indus., 284 F.2d at 325 (emphasis added). See also, FNMA v. Commissioner, 90 T.C. 405, 426 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990), *cert. denied*, 499 U.S. 974 (1991). To allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the "transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is . . . [more favorable]." City of New York v. Commissioner, 103 T.C. 481, 493 (1994), *aff'd*, 70 F.3d 142 (D.C. Cir. 1995)(quoting Television Indus., 284 F.2d at 325), For this reason, the courts have generally subjected taxpayers to a heightened standard of proof before they are permitted to contradict the form and have the transaction taxed in accordance with substance. Spector, 641 F.2d at 382; Estate of Durkin, 99 T.C. at 572-75; FNMA, 90 T.C. at 426; Illinois Power, 87 T.C. at 1431; Little, 1993 Tax. Ct. Memo LEXIS 284, at *31.

The courts have articulated this heightened standard of proof differently. See Spector, 641 F.2d at 382. For example, in Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967), the court held that where taxpayers executed a contract containing specific terms, conditions and allocations, they may not alter or avoid the tax consequences of that agreement in the absence of fraud, duress, or undue influence. In contrast, the court in Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979), determined that before a taxpayer may alter or avoid the tax consequences of a contractual arrangement, the taxpayer must come forth with strong proof that the agreement lacked economic reality. See also Little, 1992 Tax. Ct. Memo LEXIS 284 at *31 (strong proof requires a showing beyond a "preponderance of the evidence that the terms of the written instrument do not reflect the actual intentions of the contracting parties"). The strong proof standard has also been adopted by the Tax Court in adjudicating matters involving debt-equity disputes. Miller v. Commissioner, T.C. Memo. 1989-153, 1989 Tax. Ct. Memo LEXIS 153, at 20, *aff'd per curiam in an unpublished opinion*, 900 F. 2d 260 (6th Cir. 1990) (where taxpayers chose to characterize the advances as debt, the court was unpersuaded by their argument that the substance was equity when the advances contained both debt and equity characteristics).

[85] by applying the strong proof standard, it is most

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unlikely that Corporation A could reach this standard, and it is certain given the courts' phrasing of the standard that the burden would be on Corporation A to do so.

Regardless, allowing terminology to control is at the heart of contract law. In one sense, Danielson can be seen as the progeny of the long standing parol evidence rule. When interpreting a contract you look to the four corners and not what the drafter *may* have had in mind at the time of drafting the contract. If Corporation A is concerned by a possible conflict between patent and tax law due to the wording of a contract, Factor Five ensures that such a result will not occur.[86]

Corporation A entered into license agreements

. Corporation A has not adduced such proof, and cannot, given both Corporation A continue to represent that Corporation A did not sell patents or Agreement C to Corporation H.

In essence, Corporation A argues for the "right" to disavow its own licenses so it can retroactively convert ordinary income to capital gains to generate a huge tax refund. The cases discussed above and in the Year 1 RAR demonstrate that such disavowal is not allowed. Further, as established in the Year 1 RAR and not refuted by Corporation A, the law allows the Commissioner to hold sophisticated taxpayers to the form of their own unambiguous agreements.

The facts overwhelmingly support the Commissioner's position in this case. See Law and Analysis, § B.3, above (extrinsic facts confirming Corporation A licensed and sublicensed, not sold, patents and the Agreement C). The agreements are clearly

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[86] See Exhibit Two (summarizing the Six Factor Analysis applied in the Year 1 RAR, with Factor Five providing an agreement cannot be treated as a sale agreement if, applying the Waterman Rule, it would treat as a license).

licenses. The IRS not only can, but must, hold Corporation A to its unambiguous license agreements.

C. Corporation A's Retained Rights

Corporation A's transfers[87] to Corporation H cannot be sales because Corporation A retained substantial rights.

1. The Substantial Rights Test

At page 14 of the Protest, Corporation A initially quotes the "substantial rights" language of the Third Circuit in Merck as articulating the relevant test for determining whether a transfer may qualify as a sale:

> …a transfer of all of the substantial rights in a patent is deemed an assignment and qualifies the transferor for capital gains treatment. A transfer of anything less is called a license with a resultant assessment of the tax at ordinary income rates.

Merck & Co. v. Smith, 261 F.2d 162, 164 (3d Cir. 1958).

But, the Protest then inaccurately restates the test as follows: "[W]here there is a grant of all substantial rights of value in the patent rights, such grant constitutes a sale . . . ."[88] This restatement of the all substantial rights test applied in Merck is inaccurate because Corporation A changes "transfer" to "grant", and 'in a patent' to 'in the patent rights.' The term 'grant' is associated with giving a license, or allowing someone access to or use of something that is kept by the grantor (e.g., grantor trust provisions), while the term 'transfer' implies that the property is conveyed away. While 'in a patent' suggests that the entire patent will be taken into account when determining whether all substantial rights have been transferred, 'in the patent rights' suggests that only the interest of the transferor in the patent will be considered for purposes of the substantial rights test. That was not the test articulated in Merck. Further, it should be noted that the transferor in Merck was the owner of the patent, and not merely the owner of a license like Corporation A.[89] As such, Merck articulated, and applied, the all substantial rights test in the case of the patent holder, not a licensee.[90]

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[87] Uses of 'transfer' and its derivatives is without connotation as to whether the intellectual property was licensed, sublicensed, or sold.

[88] Protest, p.14 (citing Merck, 261 F.2d at 164) (emphasis added).

[89] Merck, 261 F.2d at 163.

[90] This memorandum does not address whether all rights must be transferred for the transfer of a license to rise to the level of a sale for tax purposes, and leaves open the possibility such a position could be advanced if this case were to proceed to trial.

Second, and more importantly, Corporation A ignores that the Merck court considered it important that the agreement at issue, which was transferring a patent, not a license, was exclusive even as to the transferor, which convinced the court that the transferor intended to part with all substantial rights.[91] Corporation A's grant of licenses to use its patents and sublicenses to use Agreement C to Corporation H was not exclusive as to Corporation A.[92]

Corporation A also relies on MacDonald v. Commissioner[93] and Rev. Rul. 78-328[94] for the proposition that the all substantial rights test is the applicable test for determining whether a transfer of a license, in full or in part, qualifies as a transfer of a capital asset. In particular, Corporation A relies on Rev. Rul. 78-328 for "stating that the substantial rights test is applicable to transfers of less than the entire patent interest, and in such circumstances, relates only to the rights to the particular patent which the taxpayer has in his power…."[95]

Corporation A's reliance upon MacDonald and Rev. Rul. 78-328 is misplaced, because neither authority addresses the type of transaction engaged in by Corporation A and Corporation H.

First, both MacDonald and Rev. Rul. 78-328 specifically involved transferors holding all interests in the underlying patents subject to only a single nonexclusive, royalty-free outstanding license granted not by the transferor, but by the original patent holder before the transferor acquired the patent.[96] As such, both transferors in each case were

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[91] Merck, 261 F. 2d at 164 (stating, "It is to be noted here that [the transferee] got an exclusive license and the exclusion applied to the [transferor] itself. Since, after the agreement, [the transferor] could not and [the transferee] or its licensees could practice the invention patented, it is clear, we think, that [the transferor] endeavored to part with all the substantial interest it had in the patent . . . .").

[92] Year 1 RAR pp. 6, 42. In contrast, in Agreement C, Corporation B granted Corporation A an exclusive license (even as to Corporation B). Year 1 RAR, p. 2.

[93] MacDonald v. Commissioner, 55 T.C. 840 (1971), *action on dec.*, 1972 WL 32827 (July 3, 1972), *acq.* 1973-2 C.B. 2. Protest, p. 16, n. 66.

[94] 1978-2 C.B. 215. Protest, p.16, n. 66.

[95] Protest, p.16, n. 66.

[96] See MacDonald, 55 T.C. at 857 (stating that the original patent holder "transferred all of its interest in the patents to the petitioners."); Rev. Rul. 78-328 (patent holder X corporation assigned to Y corporation a royalty-free, nonexclusive license and then "sold its remaining rights in the patent to Z corporation," so that "**Z acquired the patent already subject to a license** . . . .") (emphasis added). In Rev. Rul. 78-328, the Commissioner is very clear that the property that Z is treated as having sold is a patent:

- X is the patentee;
- X transfers a non-exclusive royalty free license to Y;
- X then transfers all of its interests in the patent to Z;

considered to have acquired the patents, which is unlike this case, wherein Corporation A obtained merely a license to Corporation B patents and claims to have transferred the license, in whole or in part, not the patents.

Second, because both transferors in MacDonald and Rev. Rul. 78-328 transferred all rights they had ever received in the patents, neither authority even applied the all substantial rights test. Further, neither authority stated that the all substantial rights test would be applied in the case of transfers of a license by a licensee, such as Corporation A.

Third, both MacDonald and Rev. Rul. 78-328 involved transferors with patent interests subject to outstanding nonexclusive licenses; however, those outstanding nonexclusive licenses were conveyed by the initial patent holder or patentee, not the taxpayer whose transfer was at issue.[97] Corporation A, as part of the consideration paid to obtain its Agreement C, transferred a license interest in the right to its future know-how and inventions to Corporation B.[98] As such, MacDonald and Rev. Rul. 78-328 should not be applied, even by analogy, to Corporation A's transfers of the interests in its own patents to Corporation H since Corporation A had already transferred interests in its patents and know-how to Corporation B.[99]

Finally, Corporation A asserts in the Protest that Exam's position in this case is "directly contrary" to MacDonald, a case in which the Service acquiesced, and Rev. Rul. 78-328, so that the Service is precluded from maintaining said position in litigation.[100] As shown above, MacDonald and Rev. Rul. 78-328 are not "squarely on point". Obviously, the Service is not precluded from distinguishing a case which presents agreements and facts different than presented in either MacDonald or Rev. Rul. 78-328, particularly where the asset being transferred is different (e.g., a license not a patent), and where the sale determination turns on the language of the agreement, the intent of the parties and, for the retained rights, consideration of all of the facts and circumstances. More importantly, however, is the fact that MacDonald and Rev. Rul. 78-328 both found transfers when the transferor transferred **all that they ever had obtained from the initial transferor and, as such, actually support the position taken by Exam in this case since Corporation A did not transfer "100 percent of any patent rights which**

- Z uses the patent from X in Z's Tor B, depreciating the patent under I.R.C. § 167;
- Z transfers everything he ever received from X to a third party;

Rev. Rul. 78-328 does not say that X, as opposed to Z, was entitled to capital gain on its two transfers.

[97] MacDonald, 55 T.C. at 856-57; Rev. Rul. 78-328.

[98] See Law and Analysis, § C.2.b.xxv (further discussion of Corporation A's grant to Corporation B).

[99] Agreement C, §§ ##, ##, ## (rights and non-exclusive licenses granted to Corporation B).

[100] Protest, p. 2, nn. 2, 3.

[it] ever held."[101] In addition, to the extent Corporation A contends it only sold part of Agreement C, these authorities preclude treating such a transfer as a sale since it does not transfer 100% of Corporation A's rights.

a. Substantial Rights: Evaluate in the Aggregate

In the Protest, Corporation A implies that each right retained by the transferor is to be evaluated separately to determine if it is substantial and, if it is not, then retention of that right will not prevent sale treatment.[102]

However, whether substantial rights were retained is determined based upon the *aggregate* of the rights retained by the transferor. While the court decisions necessarily address each retained right to evaluate whether a sale occurred, the ultimate decision is based upon a consideration of the rights retained in the aggregate (as well as the intent of the parties, language used in the contracts, and all the facts and circumstances relative to the transaction). Although certain rights are considered *per se* substantial so the retention of any one of those *per se* rights necessarily makes the transaction a mere license,[103] courts will consider all retained rights in the aggregate to determine whether a particular transaction results in a mere license whenever no *per se* substantial right was retained.[104]

Additionally, Corporation A wants to shift the focus away from the rights retained by Corporation A, to concentrate on Corporation H's ability to commercialize the products utilizing Device A under the Agreement C,[105] arguing that a transfer will constitute a sale so long as the "retained right (or limitation or restriction on the transferee) does not

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[101] MacDonald, 55 T.C. at 859. This position is consistent with the action on decision issued in response to the MacDonald case, which specifically states that "…**if the transfer disposes of something less than all of a taxpayer's rights to a certain patent as a whole, he has estopped himself from claiming the transfer proceeds constitute capital gains and not income attributable to his continuing ownership of the patent right**." 172 WL 32827.

[102] Protest, pp. 14-17.

[103] See Year 1 RAR, pp. 43-44 (*per se* substantial rights).

[104] In E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052 (3d Cir. 1970) (a case relied upon by Corporation A, Protest, p. 15, nn. 63-64), the court stated that in determining whether all substantial rights have been transferred, "the key question is whether the transferor retained any rights which, **in the aggregate**, have substantial value." 432 F.2d at 1055 (emphasis added). While the government argued that the District Court had erroneously treated each right individually, instead of in the aggregate, Third Circuit stated that the government read the District Court's opinion too narrowly, indicating that the District Court did in fact take the retained rights in the aggregate into account. Therefore, the court accepted the government's position that retained rights have to be evaluated in the aggregate, but disagreed with the government's contention that the district court failed to properly do so.

[105] Protest, p. 16. Note, again, that

interfere with a transferee's full and exclusive use of the patent rights."[106] While Corporation A acknowledges that the transferee must have the "full and **exclusive** use" for there to have been a transfer of monopoly rights, Corporation A does not acknowledge that Corporation H clearly did not have "full and exclusive use" under either the Agreement A or the Agreement B. If the grant to a transferee is not "full and exclusive", then the transferor, of necessity, has retained substantial rights. Moreover, the ability of the transferee to commercialize is not the test applicable in determining if the patent is merely licensed.

Exam agrees that considering the transaction's effect on the transferee, as well as the transferee's perspective of the transaction,[107] is appropriate, but that is because **all** the facts and circumstances are relevant to making the ultimate sale vs. license determination if an agreement is ambiguous as to whether it is a license or a sale.[108]

For example, in Lawrence v. United States,[109] the district court had entered a judgment n.o.v. (i.e., notwithstanding the jury's verdict) for the United States, holding as a matter of law that there was no sale because the right to domestic sales of the patented device had not been transferred, only the right to manufacture, use and lease the device was transferred. In reversing the district court and directing entry of judgment in accordance with the jury verdict, the Fifth Circuit demonstrated that "[w]hat is 'substantial' often becomes a factual question to be decided according to the facts and circumstances of each case and the peculiarities inherent in each patent."[110] In Lawrence, the court found the jury verdict met the "reasonable men" standard, referring to testimony that neither the transferor nor the transferee wanted the patented devices to be sold in the United States because the devices could not be operated without proper training and use of the device by inexperienced operators would damage the reputation of both the device and the transferee manufacturer. Further, the device at issue was designed to remove pipe and other obstructions from oil wells; it was a "service tool" that was used in the oil business, but it was not a tool that was held out for sale in the trade.[111] Accordingly,

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[106] Protest, p. 15 and n. 65.

[107] Federal patent law also looks at what was transferred, as well as what was retained. See Law and Analysis § D.1, below (addressing what must be transferred to assign a patent for federal patent law purposes) and Exhibit Three, below (addressing patent case law in more detail).

[108] See Law and Analysis, § B, above, addressing the Commissioner's power to hold taxpayer to the transactional form of agreements when the terms of the agreements clearly negate an intent to sell, the grant of rights is narrow and limited to a license, and the plain meaning within the four corners of the agreement are consistent with a license.

[109] 242 F.2d 542 (5th Cir. 1957).

[110] 242 F.2d at 545 (footnote omitted).

[111] 242 F.2d at 544.

even the role of the item under patent in the industry is also relevant to evaluate whether retained rights are "substantial."[112]

b. Substantial Rights: Not the Equivalent of Commercially Exploitable Monopoly Rights

Corporation A avers that the only substantial rights that are relevant to the sale versus license determination are those rights that are commercially exploitable monopoly rights so that, if the retained rights are not such commercially exploitable rights, then a sale occurred.[113] However, retained rights can be substantial even if said rights are not "commercially exploitable **monopoly**" rights.

[114] Moreover, in all but the most unusual circumstances (such as those raised in Lawrence, above), it is well established law that the rights to make, use and sell must be transferred or the agreement is a mere license.[115]

Agreement A, with its emphasis on , makes it clear that Corporation A did not transfer all substantial rights under Agreement C (and in its own related know-how and patents), but that Corporation A and Corporation H were to share the rights, while Corporation A retained significant control over [116]

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[112] As addressed in Law and Analysis, § D, below, the retention of the right to use is significant

[113] Protest, p. 15 (sale versus license standard is focused on determining "whether all the commercially exploitable monopoly rights, or substantial rights, have been transferred, with the transferor retaining only those rights consistent with, and necessary to, the protection of its status as a recipient of fixed or contingent sale proceeds….")

[114] See Law and Analysis § D.1, below (addressing the value of Device A)

[115] Id. (addressing that the rights to make, use and sell must be transferred).

[116] Of the five cases listed in the Protest (p. 15, n. 62) to support the proposition that the transferor must retain a "commercially exploitable monopoly right," Protest, p. 15, n. 62, four of the five cases involved the transfer of exclusive rights – even as to the transferor – to make, use and sell the interest: Liquid Paper Corp. v. United States, 2 Cl. Ct. 284, 291 (1983)(assignment of a secret formula found to be a sale because transferor agreed not to disclose the formula to anyone, while the transferee had the right "to authorize other persons to manufacture and sell correction fluid products based on the secret formula, thus impliedly granting the [transferee] the right to disclose the secret formula to third-party licensees"); Merck, 261 F.2d 162, 164 (transferee "got an exclusive license and the exclusion applied to the licensor itself"); Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1013 (Ct. Cl. 1967), *action on dec.*1967 WL 16240 (August 23, 1967)(after finding that a cross-licensing agreement with the

2. Corporation A Retained Substantial Rights: Agreement A

a. Corporation A Understated Its Retained Rights

Corporation A asserts that "[o]n Date 3, Corporation A transferred to Corporation H **substantially all** rights it had licensed from Corporation B [in the Agreement C] by entering into [the Agreement A].[117] Nevertheless, the Protest acknowledges many rights retained by Corporation A, such as:

Manufacturer's Aircraft Assoc. was a "previously imposed limitation" rather than a retained right, found seven of nine agreements to constitute sales because Bell "divest[ed] itself of all control and ownership in the inventions" when it granted exclusive rights to manufacture, use and sell the invention)(see Year 1 RAR, pp. 45-46, addressing Bell Intercontinental and the action on decision in more detail); Commissioner v. Celanese Corp., 140 F.2d 339, 340 (D.C. Cir. 1944)("full and exclusive right and authority to manufacture and sell in the United States and other stated territories and countries" was granted, with written assignments of the patents filed in the U.S. Patent Office; assignment was consistent with the language of the contract and was a sale).

The sole case referenced by Corporation A for support of this proposition that did not involve a transfer of rights exclusive even as to the transferor was Hooker Chemicals and Plastic Corp. v. United States, 591 F.2d 652 (Ct. Cl. 1979). In Hooker, the transferor, citing a concern over U.S. anti-trust prohibitions against territorial divisions, retained the right to import into the transferees' territories products manufactured in the U.S., and to convey know-how to its customers in said territories. The court found that, as a practical matter, it was unlikely for Hooker to exercise the right of import (shipping costs prohibitive and lack of necessary customer support for sales abroad). Significantly, however, the court did not approach the issue as one that would be resolved merely by analyzing whether the right retained by the transferor was substantial. Rather, the court in Hooker emphasized the **relevance of the parties' intent** when it summarized the analysis necessary to resolve a sale versus license dispute as follows:

> a transfer will suffice as a sale if it appears from the agreement and surrounding circumstances that the parties intended that the patentee surrender all his substantial rights to the invention. The cardinal rule in the interpretation of the contacts is to ascertain the mutual intentions of the parties and then give effect to that intention, so long as it is consistent with legal principles. The language of the agreements in their entirety must be considered as well as the total factual setting; however, the labels are not determinative.
>
> 591 F.2d at 658 (citations omitted).

Basically, if the "mutual intention of the parties", determined from the "language of the agreements in their entirety" and the "total factual setting," was for the transfer to be a sale, the retention by the transferor of a "right with no practical value will not defeat the sale status of the transaction." Id. See Year 1 RAR, pp 47-48 (addressing Hooker in more detail).

[117] Protest, p.4, Section titled "The Agreement As" (emphasis added). Note that, while the test is "all substantial rights," the Protest at this point uses the language "substantially all rights." "Substantially all rights" is not the proper test. Moreover, this misstatement implies that a transfer could meet the test if "substantially all rights" were transferred, even if one or more substantial rights were retained by the transferor, and this is clearly not the case.

- All of the “certain rights” listed in footnote 20 on page five of the Protest;
- The right to launch of Device A (Protest, p. 5);
- Know-how necessary (Protest, p. 5, n. 21)

However, the Protest understated the breadth and significance of the rights that Corporation A does admit it retained. Moreover, the rights noted in the Protest are not all of the rights retained by Corporation A.[118]

b. Over Two Dozen Rights Retained in Agreement A

Corporation A retained over two dozen rights in Agreement A, and this summary of the retained rights will show the ubiquitous nature of Corporation A’s retained rights.[119]

On an individual basis, many retained rights summarized herein are substantial, *e.g.,* retention of the right to use,[120]

, retention of the right to indulge infringement. Corporation A also retained

[121] Many of these rights, individually, are sufficient to preclude sale treatment. Moreover, when the rights are evaluated in the aggregate, it is clear that substantial rights were retained, which precludes treating Agreement A as a sale of Agreement C or a “license interest in a patent” from Agreement C.[122]

i. Decision-Making Authority

Agreement A language on retaining control over Device A in § ## is mandatory:

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[118] See Year 1 RAR pp. 6-8 (summary of Agreement A).

[119] The RAR discussed the substantial rights retained by Corporation A under Agreement B. Year 1 RAR, pp. 43-45 (identifying retained rights retained by Corporation A which, even standing alone, would be substantial). The focus in this Rebuttal is initially on the rights retained under Agreement A, with the focus of the discussion regarding Agreement B.

[120] The Protest does not contest that Corporation A retained the right to use.

[121] This is a substantial right in light of Corporation A retaining the right to use.

[122] Even if a “license interest in a patent” was sold, the license interest that was “sold” was a franchise. See Law and Analysis,§ E, below.

"

"

(emphasis added)

The Protest (p. 5, n. 20) cites to § ## as a retained right, but incorrectly describes § ## as merely granting "the right to vote (Section ##)." Corporation A's retained right is much broader and more significant. Corporation A has " " if Corporation H and Corporation A do not agree, a significantly greater right than the right to vote. This right is extant through

To fully understand the significance of Corporation A's decision-making authority regarding

[123]

[124] See Exhibit Two ( ).

ii.

[123] This benefit is tempered by Agreement C, which imposes on Corporation A the personal obligation to assure that all obligations imposed by Agreement C are met. See Law and Analysis,§ D (addressing the personal obligations imposed on Corporation A).

[124] See Law and Analysis, § E, below (discussion of the NDA as a franchise).

In § ##, pp. ##-## of Agreement A, Corporation A retained the right (

[125]

The Protest, p. 5, n. 20, agrees was retained but does not acknowledge how significant it was that this right was retained. Corporation A previously acknowledged the significance in contemporaneous documents, as follows:

- In their Year 5

  ."[126]

- In Corporation J's Year 1

  ."[127]

- Corporation A's own Memo C stated, in explaining its book treatment of Agreement A, that the "[t]he key factor in making this decision was that

  " Memo C, p. 3.

[128]

[125] In contrast, in Agreement C, Corporation A and Corporation B specifically agreed

Agreement C, Article ##: , § ## (bold added).

[126]

[127]

[128] Section ##, Commercialization, in Agreement A clearly provides that Corporation H

iii. Ownership of Corporation A's Property

Pursuant to § ## of Agreement A, each party retains ownership of the intellectual property it created or invented pursuant to the activities undertaken pursuant to Agreement A.[129]

Corporation A's right to use its own know-how is implicitly retained by lack of explicit language stating the license to use Corporation A's know-how is exclusive as to Corporation A, just as Corporation A retained the right, to use its own patents (discussed elsewhere). The Protest, p. 5, n. 21, acknowledges Corporation A retained the right to use know-how.

iv. Full Use of Corporation B's Property

As stated in the Year 1 RAR, p. 6, Agreement A does not preclude Corporation A from continuing to use its own and Corporation B's intellectual and intangible property the subject of Agreement A, *i.e*, the license is not exclusive as to Corporation A, only as to third parties.[130] Indeed, Corporation A continued to use the property the subject of Agreement A after the agreement was executed on Date 3. For example, Corporation A filed for ## patents relative to Device A on Date 5, and ## more patents relative to Device A on Date 11. See Year 1 RAR, Time Line. Corporation A could not have invented improvements to Device A if it was not using Device A.

v. Participation and Approval Re: Announcements

Section ## of Agreement A on public announcements provides for press releases. Said section also provides for of other announcements. (The retention of these rights was acknowledged in the Protest, p. 5, n. 20, but the Protest erroneously cited to § ## of Agreement A.)

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[129] There are special rules for ownership of joint inventions in § ## of Agreement A.

[130] This retention was affected by not making the grant of licenses and sublicenses to Corporation H exclusive as to Corporation A. Year 1 RAR, pp. 6, 42, 44.

vi. Oversight and Review of Corporation H's Activities

Through Corporation A retained See Agreement A,

For example:

- Corporation A retained (§ ##);
- Corporation A retained (§ ##);
- Corporation A retained (§ ##))[131]

The Protest, p. 5, footnote 20, lists these rights as separate retained rights from , which is also addressed herein as a separate retained right, above.

vii. Primary Contact

While Corporation H must pay all costs relative to , Corporation A retained the right to be the primary contact with , as follows:

Agreement A, § ## (emphasis added).

By retaining the right to be the primary contact, Corporation A retained control

[131] In Year 6, after Agreement B, Corporation H Agreement O, p. 2, ¶ 5 (also referred to as the Year 6 Amendment to the4 Agreement C Re: GSD) .

It is in this § ## that Corporation A agrees to transfer to Corporation H In contrast, it is noteworthy that nowhere does Corporation A agree to transfer Agreement C to Corporation H.

Notwithstanding the transfer of the , Corporation H (on behalf of Corporation A) must, , comply with Agreement C, §§ ##, ##, and ##. Agreement A, § ##. Corporation A has the right to take over this function, by virtue of the Agreement C obligations imposed on Corporation A, if Corporation H's performance is insufficient.

After the is transferred to Corporation H, then Corporation H can However, Corporation A continued to retain its right

:

Agreement A,§ ## (emphasis added).

[132]

By retaining

See Exhibit Two ( ). Thus, Corporation A has co-control over .

Agreement A, § ##.

[132] Year 1 RAR, Timeline, p. 67.

Agreement A, § ##.

The Protest, p. 5, n. 20, agrees these rights were retained, but fails to appraise the reader of the breadth and depth of these rights.

viii. Sublicenses by Corporation H to Non-Affiliates

Corporation A and Corporation H, two sophisticated Industry A companies, consistently referred to Corporation H's rights as merely licenses throughout the Agreement A, not as a sale or assignment. The same lexicon is used in the section of the Agreement A wherein Corporation A retained the right to pre-approve sublicensees for Country B:

Agreement A, § ##. Sublicensing (emphasis added).

ix. Rights to

Corporation A agreed to provide Corporation H

Agreement A, § ## (emphasis added).

Nowhere does Corporation A agree to sell its ownership interest in

Moreover, Corporation A previously granted Corporation B rights to
Agreement C, §§ ##; ##.

x.

Labeled as , in Agreement A, § ##,

The Protest, p. 5, n. 20, agrees this is a retained right.

xi.

While more extensively addressed in the Year 1 RAR, through the

[133] Agreement A, § ##. The Protest, p. 5, n. 20, agrees these rights were retained.

xii.

Agreement A, § ## (emphasis added).

Thus, Corporation A retained the right to participate in this critical decision.

xiii.

[133] In contrast to Corporation A's right to ultimate control , Corporation H has final decision making authority Agreement A, § ##. However, the Agreement A, §§ ## - ##.

Agreement A, § ## (emphasis added).

xiv. Rights Re:

xv. Reasonable Inspection of Books and Records

The rights of reasonable inspections are retained in Article ## of the Agreement A.

xvi. Return if Corporation H Terminates

Section ## of Agreement A provides that, if Corporation H terminates the agreement

, Corporation H shall turn over to Corporation A
Pursuant to said section, Corporation H must also transfer back to Corporation A all transferred to Corporation H. Corporation H must also return to Corporation A all of Corporation A's know-how (referred to as confidential information).

xvii. Rights to Corporation H's Property on Breach

Pursuant to § ## of Agreement A, if Corporation H breaches Agreement A, Corporation A:

Agreement A, § ## (emphasis added).[134]

xviii. Rights on Change in Control of Corporation H

Pursuant to § ## of Agreement A, then all the rights in Agreement A shall be returned to Corporation A

xix. Prosecute its Own Patents

Section ## of Agreement A provides each party is " " of its own patents,

If either party elects not to pursue filing a potential patent or prosecute, the other party will be notified and may elect to pursue, but " " Thus, if Corporation H invents an improvement (or files a patent application) and decides not to pursue the patent, Corporation A retained the right to elect to pursue obtaining the patent. If that patent is granted, Corporation A would have a perpetual, royalty-free license in the patent.

xx. Rights Re:

Pursuant to § ## of Agreement A, Corporation A retained the right to participate in

xxi. Defend Infringement Suits

Corporation A shall defend and control all suits that allege the making, using or selling of the Product in the Territory infringes on a third party's patents, subject to Corporation B's rights in the Agreement C. Agreement A, § 17.4(b).

xxii. Prosecute Infringement Suits

[134] It is noted that this quote emphasizes the importance of the restriction of the license grant in § ## of Agreement A, *i.e.*, the license is " " Section ## of Agreement A (quoted, in part, above) provides, in the event of breach by Corporation H, Corporation H is not relieved of the obligations imposed on it by Agreement A. Agreement A, § ##.

While Corporation H has the right to enforce Licensed Patents, Corporation H does not have the right to indulge infringement since Corporation A retained the right to enforce if Corporation H does not enforce. Agreement A, § ##.

xxiii. All Rights Not Granted to Corporation H

The grant clause of Agreement A, which establishes what rights are being transferred, merely granted Corporation H " " Agreement A, § ## (emphasis added).

The "exclusive license and sublicense" grant was limited to:

- **Licensed** patents
- **Licensed** Know-How[135]

Agreement A, § ## (emphasis added).

The "exclusive license and sublicense" was even specifically limited in terms of what Corporation H could use the licensed property for, *i.e.*, Agreement A specifically stated it was:

Agreement A, § ## (emphasis added).

The grant of rights to Corporation H was further limited relative to Corporation B's property as follows:

Agreement A, § ## (emphasis added).

[135] Corporation A reiterates the know-how is licensed in § ## of Agreement A, " " Agreement A, § ##.

The fact that Corporation A's compliance with Agreement C will not be a breach of Agreement A is significant. **For example, if Corporation A "claws back" rights because Corporation H is not performing pursuant to the requirements of Agreement C, Corporation H must still pay Corporation A and fulfill other obligations on behalf of Corporation A**.

Thus, notwithstanding any term in Agreement A, Corporation A would not be in breach of Agreement A if Corporation A's actions were to comply with Corporation A's on-going obligations in Agreement C.

This limited license/sublicense to Corporation H is in accord

[136]

xxiv. Additional Retained Rights

Multiple other rights were also retained in addition to those listed above. For example,

- Corporation A retained " "[137]
- Corporation A can still use Corporation B's (Year 1 RAR, p. 4, n. 7)
- Corporation H cannot assign Agreement A without Corporation A's prior written permission. (Agreement A, § ##).
- The agreement cannot be amended or modified except in writing. (Agreement A, § ##).

[138]

[139]

136

137 Protest, p. 5, n. 20.

138 For example, subject to the terms in Agreement C, Corporation A could patent its inventions relative to improvements to, , Device A in countries where Corporation B or one of Corporation B's licensees had not yet filed patents.

139 Protest, p. 2.

xxv. Corporation A Retained Agreement C

There can be no question that Agreement C was not sold to Corporation H. If the license was sold, Corporation A would not have been in the position of having to if Corporation H did not [140] Nor would Corporation A be able to

[141]

[142]

Because Corporation A granted Corporation B free, perpetual rights in Corporation A's know-how (Agreement C § ##), in Corporation A's improvements (Agreement C, § ##, with improvements defined broadly in Agreement C, § ##), and in Corporation A's (Agreement C, § ##) as part of the consideration to obtain Agreement C, Corporation A had already transferred out rights to future know-how and to Corporation B. Having granted rights in future intellectual/intangible property that Corporation A would develop pursuant to Agreement C as consideration to obtain Agreement C, Corporation A no longer owned all rights in the property. Thus, Corporation A cannot grant Corporation H all rights in the subject of Agreement C to Corporation H since Corporation A obtained the benefits of Agreement C by previously granting the future rights to Corporation B. Corporation A can only sublicense to Corporation H – subject to the rights Corporation A already granted to Corporation B for valuable consideration – Agreement C. As another consequence, Corporation A could not sell its know-how because Corporation A had already licensed it to Corporation B.[143]

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[140] For example,

Agreement A, § ##.

[141] Corporation A

[142] See Agreement C § ## (
).

[143] See Year 1 RAR, pp. 45-46 (addressing transferring rights in patents or know-how subject to pre-existing licenses granted by the transferor to third parties other than the transferee).

Clearly, the limited license and sublicense granted Corporation H, together with the rights retained by Corporation A under Agreement A, not only gave Corporation A substantial control over Corporation H's ability to use and sell; Corporation A also retained the ability to use, or not use, the patents at issue due

Accordingly, Corporation A retained substantial rights in the aggregate.

c. Applicable Case Law

Corporation A downplays the applicability of three cases cited by Exam, Allied Chemical Corp. v. United States,[144] Oak Manufacturing Co. v. United States,[145] and Schmitt v. Commissioner,[146] arguing that the cases are distinguishable because the cases all involve "transferors who retained the right to commercialize products under their patents separate and apart from their transferees."[147] In other words, Corporation A posits that the control that Corporation A continued to exert over the commercialization of Device A should be considered to be irrelevant because the control related only to the manner in which Corporation A and Corporation H worked together commercialize the product. This position is nonsensical; by maintaining control Corporation A maintained substantial rights even if it was agreed that further commercialization, pursuant to Agreement C, would be done jointly with Corporation H.

Corporation A states that the transferor in Allied Chemical Corp. retained much more control than Corporation A did in Agreement A.[148] Although the transferor in Allied Chemical Corp. retained different rights than those rights retained by Corporation A, what is significant is that Corporation A still retained control, even if it did so by retaining rights different than those retained in Allied Chemical. For instance, Corporation A retained the right to use, retained control over , restricted Corporation H's ability to , or to

[144] Allied Chemical Corp. v. United States, 370 F.2d 697 (2d Cir. 1967), Year 1 RAR p. 44.

[145] Oak Manufacturing Co. v. United States, 301 F.2d 259 (7th Cir. 1962), Year 1 RAR, p. 44. This case is addressed in more detail in Law and Analysis § D, below.

[146] Schmitt v. Commissioner, 271 F.2d 301 (9th Cir. 1959) (one year – 1949 – pre-§ 1235, two years – 1950 and 1951—post-§ 1235) (Congress retroactively amended the 1939 Code in 1956, 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).

[147] Protest, pp. 17-18.

[148] Protest, p. 18.

, and Corporation A actually granted a license to Corporation B to use Corporation A's future know-how, inventions, when Corporation A obtained Agreement C. In Allied Chemical Corp., the transferor retained the right to manufacture, use, and sell in fields other than the one in which he granted rights to the transferee, and retained the right to grant a single sublicense to one other party. Because Corporation A already granted Corporation B licenses to use its know-how outside the Territory and, among other retained rights, retained the right to use and , Corporation A, as did Allied Chemical, retained substantial rights in the aggregate.

While Corporation A acknowledges that the court identified many substantial rights in Oak Manufacturing Co., Corporation A focuses upon the fact that the license term in Oak Mfg. was shorter than the patent term, which factor is distinguishable from the agreements Corporation A had with Corporation H. However, this focus again ignores the requirement to view the stated intentions of the parties, all of the terms in the agreement, and all of the related facts and circumstances and instead just points to one characteristic present in Oak Mfg. that is not present in Agreement A or Agreement B. It is notable that the Protest does acknowledge, albeit in a footnote, that the Court in Oak Mfg. viewed the terms of the agreement as contemplating "a continuing business relationship for distributing Oak products in new markets."[149] That is exactly what was contemplated in Agreement A: a continuing business relationship for distributing Device A in the Country B market.

Corporation A suggests that the rights retained in Schmitt are unlike the rights that Corporation A retained.[150] In Schmitt, the transferor failed to transfer the right to manufacture, and retained other rights such as the right to veto a sublicense.[151] While Corporation A's Agreement A transfers the right to manufacture the licensed Device A and to commercialize the , Corporation A's Agreement A does not transfer to Corporation H the exclusive (even as to Corporation A) right to use, which is a *per se* substantial right.[152] In addition, Corporation A retains all of the rights summarized above. Finally, Corporation A states that Schmitt was based on the predecessor to § 1235 and thus required the transferor to transfer his entire interest, ignoring that not all years at issue were subject to § 1235.[153] However, Schmitt stated that "we think, realistically considered, [the transferor's retained rights] more closely

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[149] Protest, p. 18, n. 78 (citing to Oak Mfg., 301 F.2d at 262).

[150] Protest, p. 18.

[151] Schmitt, 271 F.2d at 307.

[152] Year 1 RAR, pp. 7, and 43-45.

[153] Protest, p.19. The proper role of § 1235 cases to this transaction is addressed in Law and Analysis, § D, below.

resemble a licensor's control of a licensee than an assignor's sale of 'all substantial' property rights."[154]

Corporation A suggests that its transfers to Corporation H are similar to the transfers in Rollman, Lawrence, and Bell Intercontinental Corp. so that none of the rights retained by Corporation A matter.[155] However, each case is distinguishable from Corporation A's transfers.[156]

Corporation A maintains that retention of a right of approval before Corporation H could subcontract its obligations does not preclude sales treatment because, quoting Rollman, "'[s]uch a limitation does not interfere with the full use of the patent by the assignee and it serves to protect both parties to the assignment….'"[157] In Rollman, however, the court reasoned that the limitation at issue did not interfere with the transferee's full use of the patents because the transferors granted exclusive rights in the patents to the transferee and retained no use of the patents.[158] Since the court concluded that the transferors did not retain the right to use the patents, the Rollman court did not consider the issue presented herein: would this limitation, held in conjunction with the retained right to use the patent, constitute a substantial retained right? The court does seem to suggest that, had the transferors retained use of the patents, the limitation at issue could interfere with the transferee's full use of the patent,[159] which of course would preclude sale treatment.

Corporation A also relies on Rollman for the proposition that "retained rights like those . . . that serve to protect the transferor's status as a recipient of contingent sale proceeds do not prevent a sale."[160] Specifically, Corporation A quotes Rollman as saying,

> The authorities do not support the view that the grant of exclusive rights under a patent does not amount to a transfer of a capital asset if . . . [a

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[154] Schmitt, 271 F.2d at 307 (emphasis added).

[155] Protest, pp.16-18.

[156] Lawrence, 242 F.2d 542, is addressed at § C.1 a. above (Substantial Rights: Evaluate in the Aggregate); Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967), is addressed in detail in the Year 1 RAR, pp. 45-46.

[157] Protest, p.16 (quoting Rollman, 244 F.2d at 640).

[158] Rollman, 244 F.2d 634, 639-40.

[159] Specifically, directly after stating that the limitation at issue did not interfere with the transferee's full use, the court stated, "Moreover, the [transferor] retains no use of the patent for himself by reason of the limitation since he has granted the exclusive rights to the assignee and cannot grant a sublicense without the purchaser's consent." Rollman, 244 F.2d at 640.

[160] Protest, p.16.

right retained] serves to protect both parties . . . in case the purchase price is paid in installments [sic].[161]

However, the quoted material does not accurately convey what the court stated. Corporation A substitutes the phrase "a right retained," where the court uses the phrase "a limitation," and combines two separate sentences, both of which should be read in light of the other. Finally, Corporation A omits the conjunctive used by the court, in order to suggest that if the right retained serves to protect both parties, even if such right interferes with the transferee's full use, then sale treatment should not be precluded. Corporation A's suggestion lacks merit. If a retained right interferes with a transferee's full use of the transferred property, the retained right will be substantial even if said right also serves to protect both parties.

d. Retained Rights: Not Mere Security Interests

Although Corporation A asserts that it retained "**only** those rights that would ensure Corporation H's diligence and payment,"[162] the Protest does not provide an analysis showing why the retained rights should be viewed as being solely in the nature of retained "security interests." The Protest also explained Corporation A's retention of rights as being the means "

"[163] That explanation implies more than the mere retention of a security interest intended only to protect an income stream. Rather, said statement reveals that the retained rights were intended to affect the success of the commercialization endeavor.[164] In other words, Corporation A and Corporation H were going to be in the commercial endeavor together.

In the Protest, p. 24, Corporation A claims that that all of the rights retained by Corporation A "served to protect Corporation A's continuing obligations as a guarantor." Keeping in mind that Corporation A was not just a guarantor,[165] the controls clearly are

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[161] Protest, p. 16, n.69 (quoting Rollman, 244 F.2d at 639-40).

[162] Protest, p. 1.

[163] Protest, p. 17.

[164] In the long run, it could be argued that almost any cooperative or contractual commercial venture between unrelated parties constitutes a "security agreement" since each party to the agreement wants to make sure that the endeavor is profitable and are merely trying to secure said expectation of profits by their agreement. At a certain point, however, when the rights retained are both proactive to the venture the subject of the agreement, and capable of being used separately, the retained rights indicate that more than a security interest was retained.

[165] Agreement A specifically states there is no third party beneficiary. Agreement A, § ##. In addition, as established in the Year 1 RAR and confirmed in Law and Analysis, § B 1 and 2, above, Corporation A

not mere security interests since they are not just conditions subsequent that "kick in" when Corporation H fails to pay or otherwise misses a deadline.

Further, Corporation H already had its own stakeholder interests to protect, *e.g.,* Corporation H's market share . If Corporation H violated the terms of Agreement A (or if Corporation A breached Agreement C or Agreement L with Corporation B), Corporation H would not be able to sell since the patents on Device A are owned by Corporation B. Both Corporation H and Corporation A need Agreement C to be in full force and effect to protect each one's profits and their right to use Device A, as well as to market and sell Device A.

In addition, Corporation A did not, and could not, transfer all its rights under Agreement C to Corporation H because Corporation A had to be able to fulfill all of its personal obligations imposed by and in the Agreement C. For example, Corporation A agreed that

> It is hereby understood that by designating such a third party to be responsible **CORPORATION A will not be relieved** from assuming all its obligations under this Agreement.

Agreement C, § ## (emphasis added).

The obligations imposed on Corporation A were significant, and failure to meet the obligations would allow Corporation B to convert Agreement C, so it was no longer exclusive, or terminate. Year 1 RAR, pp 1-2. Corporation A claims Agreement C is not personal to Corporation A, which is disputed in Law and Analysis, § D, below. Yet, nowhere in the Protest does Corporation A actually address the obligations imposed on Corporation A by Agreement C, other than to claim that all of the rights retained by Corporation A "served to protect Corporation A's continuing obligations as a guarantor." Protest, p. 24. These obligations implicitly require Corporation A to retain rights in the subject matter of Agreement A and Agreement B in order to be able to fulfill the obligations. Ignoring the obligations imposed on Corporation A cannot nullify their effect, and labeling a substantial retained right a 'security interest' does not make it so.

3. Corporation A Retained Substantial Rights: Agreement B

a. Corporation A Continued to Retain Substantial Rights

Corporation A continued to retain substantial rights even after Agreement B. Specifically, in addition to discussed below, Corporation A retained:

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continued to be a party to Agreement C, retaining both the license, with the benefit of continued personal use, and Corporation A's personal obligations imposed in Agreement C.

- Ownership of all of its intellectual property and inventions.[166]
- Right to use all of Corporation B's intellectual property,
- Right to its own .
- Right to participate
- Right to use Corporation A's own know-how,
- Right to Corporation H's intellectual property in the event of Corporation H's breach or termination.
- Right, and obligation, to defend all suits that allege making, using or selling of the Product in the Territory infringes on a third party's patents (subject, of course, to Corporation B's rights in Agreement C).
- Right to prosecute third party infringement of the Licensed Patents, if Corporation H does not enforce said Licensed Patents.
- Right to supply,
- Right to approve sublicenses, albeit modified to state approval would not be unreasonably withheld.
- Right to .
- Right to negotiate with Corporation H to be [167]

Moreover, Corporation A continued to remain the sole party with Corporation B under Agreement C.

In addition, the following assertions within the Protest are incorrect:

[166] The portion of section ## of Agreement A, which addressed the continuing ownership of intellectual property, remained intact following Agreement B. Section ## of Agreement B provided that Agreement A remained in full force and effect, with the provisions of both Agreement A and Agreement B to be given effect, with only inconsistent terms to be controlled by Agreement B's terms.

[167]

- That the on-going royalties, based on a percentage , are paid for services. Protest, p. 37. That is clearly not the case, as the terms for the royalties quoted in the Year 1 RAR, p. 16, n. 26, establish. Corporation H reports in its financial statements

- That Corporation H obtained sole authority and responsibility for all commercialization activities, with Corporation A no longer entitled to participate or vote in any commercialization activities except as required by Agreement C. Protest, p. 7, n. 32. Rather, Agreement B provided that the

- That Corporation H could " " Protest, p.16. Actually, Corporation H was required to order the supply of Device A from Corporation A (Agreement B, § ##). Additionally,

[168]

b.

Pursuant to Agreement B to Agreement A, Corporation A The paragraph that retained this substantial right stated:

168

[169] [170]

Agreement B, § ## (emphasis added).

As a result of retaining the right to use both Corporation B's and its own patents and know-how, Corporation A had the right to

[171]

[169] Agreement A, § ##, defines " .
Corporation A's response to IDR No. ## explained that the first ## patents listed on said schedule are Corporation B's patents, which were sublicensed with all of the other listed patents belonging to Corporation A, which were licensed rather than sublicensed. Corporation A's referenced response to IDR No. ### was e-mailed to the IRS by , but titled "Proposed Response to " Corporation A never withdrew or finalized the IDR response. A copy of Schedule ## is attached to the IDR response.

It is noteworthy that even in this response to IDR No. ## that Corporation A sent to the IRS, Corporation A states that the rights are licensed or sublicensed, not sold, to Corporation H. Stating, for example, "Intellectual property in the form of patents ('Patented IP') was licensed to Corporation H. . . . " (emphasis added) The two page narrative response reiterates many times that both Corporation A's and Corporation B's patents were licensed or sublicensed, as the case may be. It is never asserted that any interest in these patents was sold to Corporation H.

[170] The Agreement A, § ##, defines " " to "
"

[171] Agreement B is unambiguous, so no extrinsic evidence is admissible to construe it. However, if extrinsic evidence was admissible, it would establish that Corporation A retained this right,
Extrinsic evidence establishes that

However, the Protest argues the retention of the right to
is not a substantial right
because (1) the is not valuable[172] and/or (2) Corporation A cannot exploit the retained right.[173] Both arguments are refuted below.

Corporation A also argues that it

174

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[172] The Protest, p. 25, n. 108, contends Corporation A does not have to establish that the retained right lacked value as of the date Agreement B was executed. Corporation A argues, instead, that if it establishes there is no practical or commercial value, then that is sufficient. Corporation A references the string of cases cited at nn. 58-69 as supporting said position (Protest, n. 108). However, the cases cited do not stand for the proposition Corporation A asserts. Fair market value is the long accepted valuation standard for tax valuation purposes. In contrast, fair value, which is used for book purposes, has no bearing on the issues addressed herein. Corporation A appears to claim that E.I. du Pont de Nemours and Co. v. United States, 296 F. Supp. 823 (D. Del. 1969), *aff'd in part, rev'd in part* 432 F.2d 1052 (3d Cir. 1970) establishes a practical value can be used in lieu of fair market value. The IRS disagrees with, and objects to, the valuation standards used E.I. du Pont. Action on Decision, 1970 WL 22778 (IRS AOD) ("The court held that taxpayer retained no substantial rights. An appeal is indicated because (1) a retained right producing revenue of over $1,100,000 is hardly insubstantial, (2) there was no adequate evidence to show the retained right to use certain of the patents to make dacron was without value, . . . ").

[173] Protest, pp. 8, 25-28. Exam's position on the cases string cited in the Protest at page 25, n. 105, has been addressed in the RAR and elsewhere in this memorandum. However, at this point, it is to be particularly noted that none of the cited cases are relevant to this case unless Corporation A can establish that has **no** value.

174

Moreover, Corporation A's professed lack of any knowledge[175] is explicitly contradicted by the Date 12 ## p.m. e-mail from

[176]

In addition to lacking credibility, this argument as to the "why" the right was retained must be rejected as simply irrelevant – what matters is that the right was, in fact, retained by Corporation A in the signed agreement.

As Corporation A did in the audit, the Protest simply concludes that there was no value associated with However, Corporation A has not provided an expert report on the value of , as of Date 9, the date Agreement B was signed.[177] The transferor has the burden to show that the rights retained had no value.[178] Without an expert valuation, Corporation A has failed to establish even a *prima facie* case as to lack of value. Further, the arguments relative to the should be rejected.[179]

i. The is Valuable

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[175] Notwithstanding that it failed to establish the the Protest argues that the IRS should just accept that the right is Protest, p. 8 (emphasis added). The Protest reiterates this argument, at page 26.

[176] If Corporation A provides a full explanation Exam requests that the explanation be reduced to writing by Corporation A, and forwarded to Exam for consideration and comment.

[177] It is probable that experts could be found by Corporation A. For example,

[178] See Young v. Commissioner, 269 F. 2d 89, 93 (2d Cir. 1959) (the transferor failed to carry its burden of proof to establish the retained rights are not substantial and had no value); see also Year 1 RAR, pp. 36-38 and 44 (addressing cases where a field of use was retained, but the transferor established the retained use lacked value).

[179] This is discussed further in section ii.

The objective facts establish the did have value at the time of the execution of Agreement B.

In the Protest, Corporation A confirms Protest, pp. 26-27. The fact that the , is strong corroborating evidence of value.

In addition, as of the execution of Agreement B, Corporation A

[180] This is strong corroborating evidence of value.

[181]

[182]

The Protest, p. 28, n. 121, attempts to sidestep the impact of by arguing that Agreement A, Article ##, required that Corporation A

[183]

[184]
[185]

180

[181] Id. (emphasis added).

[182] Id.

[183] This aspect of Agreement A was not changed by §§ ## and ## of Agreement B relative to

[184] Id.

[185] Id.

[186]

Moreover, Corporation A implicitly concedes that

ii. The Cannot Be Construed to Preclude Exercising the Retained Right

Corporation A argues the

Protest, p. 8.

Thus, Corporation A argues the rights However, principles of contract construction require interpretation of agreements in a manner which would give effect to both . Restat 2d of Contracts, § 203. Specifically, § 203(b) states that an interpretation which gives effective meaning to all the terms takes preference over an interpretation that leaves a part as having no effect.

> § 203 Standards of Preference in Interpretation
>
> In the interpretation of a promise or agreement or a term thereof, the following standards of preference are generally applicable:
>
> (a) an interpretation which gives a reasonable, lawful, and effective meaning to all the terms is **preferred** to an interpretation which leaves a part unreasonable, unlawful, or of no effect;

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[186] As an aside, even if Corporation A

(b) express terms are given greater weight than course of performance, course of dealing, and Country Bge of trade, course of performance is given greater weight than course of dealing or Country Bge of trade, and course of dealing is given greater weight than Country Bge of trade;

(c) specific terms and exact terms are given greater weight than general language;

(d) separately negotiated or added terms are given greater weight than standardized terms or other terms not separately negotiated.

Restat. 2d of Contracts, § 203.[187]

Agreement B § # cannot be construed so that the nullifies the without violating the contract construction precept quoted above. The

[187] The comments to the section are quoted below (emphasis added).

a. Scope. The rules of this Section are applicable to all manifestations of intention and all transactions. They apply only in choosing among reasonable interpretations. They do not override evidence of the meaning of the parties, but aid in determining meaning or prescribe legal effect when meaning is in doubt.

b. Superfluous terms. Since an agreement is interpreted as a whole, it is assumed in the first instance that no part of it is superfluous. The parties may of course agree to supersede prior manifestations of intention; indeed, this is the normal effect of an integrated agreement. See § 213. **But, particularly in cases of integrated agreements, terms are rarely agreed to without reason. Where an integrated agreement has been negotiated with care and in detail and has been expertly drafted for the particular transaction, an interpretation is very strongly negated if it would render some provisions superfluous.** On the other hand, a standard form may include provisions appropriate only to some of the transactions in which the form is to be used; or the form may be used for an inappropriate transaction. Even agreements tailored to particular transactions sometimes include overlapping or redundant or meaningless provisions.

The preference for an interpretation which gives meaning to every part of an agreement does not mean that every part is assumed to have legal consequences. Parties commonly direct their attention to performance rather than breach, and it is enough that each provision has meaning to them as a guide to performance. Stipulations against particular legal consequences are not uncommon. Thus it is not unusual to define the intended performance with precision and then to provide for tolerances within which variation is permitted. See Uniform Commercial Code § 2-508(2).

c. Unreasonable and unlawful terms. **In the absence of contrary indication, it is assumed that each term of an agreement has a reasonable rather than an unreasonable meaning**, and that the agreement is intended to be lawful rather than unconscionable, fraudulent or otherwise illegal. But parties are free to make agreements which seem unreasonable to others, and circumstances may show that even an agreement innocent on its face has an illegal purpose. The search is for the manifested intention of the parties. If a term or a contract is unconscionable or otherwise against public policy, it should be dealt with directly rather than by spurious interpretation. See § 208 and Uniform Commercial Code § 2-302 and Comment.

must be construed so as to give effect to the

.

iii. Corporation A Can Exploit the Retained Indication

The Protest, avoiding Corporation A's failure to establish

Protest, p. 25. This is not correct. Exam considered Corporation A's arguments and contentions, rejecting both as insufficient for the reasons stated in the Year 1 RAR, and re-stated and confirmed below. Corporation A's arguments just do not

Agreement B, § ##, ### sentence (emphasis added).

Not one argument advanced by Corporation A relative to that

- Corporation A argues, without an independent expert report to support the argument, that

  Protest, pp. 26-27.

  - Corporation A <u>bases this argument on an analogy to</u>

    .

    Protest, pp. 26-27.

- [188]
- Moreover, that

- Next Corporation A argues that, [189] Protest, pp. 27-28.
  -
  -
  - <u>For example</u>,
  - [190]

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[188]

[189] The Protest assumes

[190] The Protest, pp. 27-28, n. 120, speculates

- Corporation A contends that

[191] Protest, p. 27.

  - Yet, Thus, this argument means nothing.
  - Without an independent expert to testify on the value

The Protest did not establish that Corporation A could [192]

Thus, Corporation A failed to establish that Corporation A cannot

[191] While the Protest at page 27, on its face, almost appears to argue that , we doubt that is what Corporation A meant and if it so meant, doubt that would happen.

[192]

In the Protest, Corporation A attempts to persuade the reader that all of its self serving arguments are actually "facts." Protest, p. 28, first sentence. However, self-serving speculative arguments are not facts. What is a fact, and does establish a *prima facie* case of value, is Corporation A's

[193]

Given the amount of money that is at stake for Corporation A, and Corporation A's contacts in the Industry A, if a qualified independent expert would have opined that there was no value

, Corporation A would have, and could have, provided independent expert valuations. Corporation A did not provide any independent expert reports to support its arguments, evidence that the independent experts would not so opine. Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158, 1165 (1946), *aff'd* 162 F.2d 513 (10th Cir. 1947).

D. Necessity of Corporation B's Consent to Sell Agreement C and Applying the Waterman Rule

The agreements at issue preclude Corporation A from selling Agreement C without the explicit permission of Corporation B, and Corporation B did not consent to a sale so the agreements cannot be treated as selling Agreement C,[194] as addressed in Section D.1, below.[195]

The Protest asserts tax law has evolved away from applying the rule articulated in Waterman v. MacKenzie, 138 U.S. 252 (1891).[196] Tax law still applies the Waterman

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[193] In the Protest, p. 25, n. 107, Corporation A argues that if Agreement A constituted a sale then Agreement B could be a grant back of a license two years later. In support of the "then" clause, the Protest cites to Lamar v. Granger, 99 F. Supp. 17 (W.D. Pa. 1951) and Ruge v. Commissioner, 26 T.C. 138 (1956), acq., 1958-2 C.B. 7. However, the premise is not met; Agreement A is a mere license. Accordingly, the "then" clause does not help Corporation A.

[194] Even if Corporation A did have Corporation B's permission to sell the Agreement C, the inquiry would not stop there. Agreements transferring licenses are subject to the rules of contract law, the rule allowing the Commissioner to hold taxpayers to the form of their agreements and, at a minimum, cannot be treated as selling the license if the transferor retained substantial rights, as addressed in other sections of this memorandum.

[195] See Exhibit Three, below (addressing patent law relative to assignments of licenses).

[196] See Exhibit Three, below (addressing patent law and patent cases applying the Waterman Rule to find transfers of patent interests mere licenses).

Rule when determining whether a transaction transferring a patent is a mere license, [197] as confirmed in Section D.2, below.

With respect to applying tax law, Corporation A errs to the extent it asserts I.R.C. § 1235 applies to a transfer of a license by a C corporation; but, if Section 1235 could be applied by analogy, it would preclude the agreements at issue from begin treated as selling Agreement C in full or part, as addressed in Section D.3, below.

1. Corporation A's Position Re: Selling the Agreement C

The Protest does not dispute Exam's position that the agreements in issue and patent law preclude Agreement A and Agreement B from being treated as selling Agreement C if the patentee (Corporation B) did not consent to a sale. Rather, the Protest: (a) argues Corporation B consented to a sale of Agreement C, (b) argues Agreement C is not personal as to Corporation A; and (c) argues against positions Exam never asserted.

a. Corporation B Never Consented to a Sale

The Protest errs when it concludes that Agreement L approved a sale.[198] Agreement L merely approved a sublicense.

Agreement C expressly states that it cannot be assigned without prior written permission:

Agreement C, § ##, Assignment (emphasis added).[199]

Agreement C also provides that Corporation A needs Corporation B's prior written approval to sublicense to a non-affiliate.

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[197] The Year 1 RAR adopted, verbatim, the advice of counsel as set forth in the April CSLA. The RAR, at pages 36-38, asserted Merck & Co. v. Smith, 261 F.2d 162 (3d Cir. 1958) and E.I. du Pont de Nemours and Co. v. U.S., 432 F.2d 1052 (3d Cir. 1970) do not establish tax law no longer applies the Waterman Rule.

[198] Protest, p. 14.

[199] See Exhibit Three, below (generally, a license is not divisible for sale purposes).

Agreement C, § ##.

The language in Agreement C prohibiting assignment is strong, without qualification. Agreement C cannot be assigned, in full or part, without Corporation B's explicit prior written consent to assign. The language on sublicensing is softer, but still qualified, stating Corporation B will not unreasonably withhold consent to sublicense, but that prior written consent is still needed for an assignment to a non-affiliate.

Agreement L provides the Agreement C-required written approval to sublicense, <u>not</u> approval to assign. The words of the written approval in Agreement L between Corporation B and Corporation A strictly limited the approval to a sublicense, as established by the plain language of the Agreement L,[200] with the quoted language set forth in bullet points.

- [201]
- [202]
    - [203]
    - [204]
- "Corporation B agrees that [205]

[200] <u>See</u> Law and Analysis, § B, <u>above</u> (addressing the critical importance of the language within the four corners of an agreement).

[201] Agreement L, p.#, § # (emphasis added).

[202] Agreement L, p. # (emphasis added).

[203] Agreement L, p. #, § # (emphasis added).

[204] Agreement L, p. # , § # (emphasis added).

[205] Agreement L, p. #, § # (emphasis added).

In addition, Corporation A stated in its Memo C, drafted after Agreement B was executed, that Agreement L granted consent to sublicense to Corporation H, as follows.

Memo C, p. 4 (emphasis added).

Thus, Corporation A's own draft memorandum to the files refutes its new[206] claim that Agreement L approved a sale of Agreement C.

The Protest argues that Agreement L must have been approving a sale <u>because</u> Agreement L consented to Corporation A entering into Agreement A.[207] That assertion would follow <u>only if</u> Agreement A was <u>actually</u> a sale agreement. Agreement A is not a sale agreement, as shown above.

Thus, the Protest errs. Corporation B did not consent to a sale of Agreement C in Agreement L.

b. Corporation A's Obligations are Personal

Corporation A also asserts the obligations in Agreement C are not personal to Corporation A,[208] implicitly acknowledging a license with personal obligations cannot be sold without the patentee/licensor giving permission to sell. Both law and patent law provide that a license that imposes personal obligations on the licensee cannot be sold without the permission of the licensor.[209] However, Corporation A errs in asserting that Agreement C is not personal as to Corporation A.

The very first

Agreement C, Article #, , § # (emphasis added). Agreement C specifically provides, even if Corporation A does designate another to perform its obligations

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[206] During the audit, Corporation A alleged Corporation B's approval was not needed because there were no substantial changes to Corporation H's rights.

[207] Protest, p. 14.

[209] <u>See</u> Exhibit Three (full discussion supporting this assertion).

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Agreement C, § 11.2 (emphasis added).

The provisions of Agreement L reiterated that Corporation A's obligations under Agreement C remain personal as to Corporation A, notwithstanding the approval of a sublicense to Corporation H. For example, Agreement L stated:

- Agreement L, p. #, ¶ #. Consent to Sublicense.
- " " Agreement L, p. #, § # (emphasis added).
- " " Agreement L, p. #, § # (emphasis added).

Memo C specifically stated that "**Corporation A remains obligated to perform under the Corporation B Agreement**" Memo C, p. 4 (emphasis added). The Memo C further stated:

> Although Corporation H has agreed, under the terms of the **outlicensing** agreements, to assume or perform many of Corporation A's obligations to Corporation B under the Corporation B Agreement, Corporation B is not a party to the Corporation H Agreements. As such, **Corporation A remains a contractual obligor under the Corporation B Agreement**.

Memo C, p. 5 (emphasis added).

Thus, the plain and unambiguous language of Agreement C and Agreement L establish the Agreement C obligations are personal to Corporation A, with this not changed by Agreement B. Because Agreement C is personal as to Corporation A, the license cannot be sold without the consent of Corporation B. See

[210] (emphasis added).

To the extent that Corporation A argues it only sold part of Agreement C, using the phrase "a license interest in a patent" to connote such,[211] Corporation A's arguments must still be rejected because, among other reasons, as a general rule, licenses are not divisible for sale purposes. See Jan E. Lehman, Anne E. Melley and Elizabeth A. Brainard, Patents, § XXXI Licenses, § D Transfer, 60 Am. Jur. 2d patents § 1060 (copyright 2011) ("**Even if assignable, a patent license is ordinarily assignable only in its entirety, and is not divisible**.")(emphasis added, citations omitted).

c. Corporation A Addresses Arguments Not Advanced

In closing its arguments relative to its claim to have sold a license, Corporation A asserts the Year 1 RAR argued, because Corporation A did not own Corporation B's patents, that Corporation A could not sell its Agreement C.[212] The Year 1 RAR made no such argument. What the Year 1 RAR argued, at page 48, is that, pursuant to federal patent law, a licensee could not sell its license interest without explicit approval of the patentee.

Corporation A has cited no tax or patent case which holds a license can be sold, in full or part, without the explicit permission of the patentee. Corporation A has not refuted that the Agreement C precludes selling the Agreement C, in full or part, without Corporation B's prior written permission. Agreement C, § #. Accordingly, as found in the Year 1 RAR, Corporation A cannot be treated as selling Agreement C, in full or part, because Corporation B did not explicitly consent to a sale of Agreement C.[213]

2. Tax Decisional Law Still Applies Waterman Rule.

The Protest relies on I.R.C. §§ 1221, 1222 and 1231 to assert Corporation A is entitled to capital gain treatment.[214] None of these Code sections, nor the regulations

[210] This treatise cited, for support,

[211] Protest, p. 33.

[212] Protest, p. 33.

[213] Should Corporation A contend, in the alternative, it sold , that argument would lack merit. Corporation A previously licensed rights to Corporation B and retained control by its retained rights in the Agreement A. See Facts, above (section addressing Corporation A's retained rights relative). See also Exhibit One (responsibilities of an holder). Moreover, is a franchise, so the income from transferring is ordinary as addressed in Law and Analysis, § E, below.

[214] Protest, pp. 1 and 11.

promulgated thereunder, define what constitutes a sale of either a patent or a license to use a patent. Further, to be entitled to capital gain treatment, Corporation A must establish that the "sale or exchange" requirement of tax law has been met.

The Year 1 RAR cited to federal tax decisional law that applied the Waterman Rule in determining if an agreement transferring interests in patents can rise to the level of a sale for tax purposes. Among other cases,[215] the Year 1 RAR cited to the tax case of Kronner v. United States, 110 F. Supp. 730 (Ct. Cl.1953). Kronner opined that whether an agreement transferring an interest in a patent can meet the "sale or exchange" requirement of tax law must be resolved in light of patent law because the necessary terms for a sale of a patent "have become peculiar to the patent field." Kronner, 110 F. Supp. at 734-735 (emphasis added). Kronner was cited with approval by Congress relative to the case law that should be followed for cases outside of the scope of § 1235, as is Corporation A's case. S. Rep. No. 83-1622, *as reprinted in* 1954 U.S.C.C.A.N. 4621 at 5082.[216]

Corporation A disagrees, asserting tax law has evolved away from applying the Waterman Rule to determine if a patent has been sold or licensed.[217] However, the Protest does not explain **why** it focuses primarily on the federal patent law relative to selling patents if Corporation A no longer contends it sold any patents.[218]

Regardless, the Protest does not cite any federal government pronouncement that tax law has evolved away from patent law relative to the impact of the Waterman Rule on the determination of whether a transfer of a patent is a mere license. Indeed, it cannot.

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[215] See Year 1 RAR, pp 29-30, 33-41 (additional case law to the same effect).

[216] There are situations where there does not appear to be a clear statement of how the Waterman Rule would be applied, so there is published guidance. For example, the Year 1 RAR, p. 46, pointed out that the question of whether, for federal patent law purposes, transferring a patent subject to a pre-existing license would impermissibly split the statutorily-granted monopoly did not appear to have been decided back in 1978. Thus, the Commissioner published its position. If a taxpayer-transferor receives a patent subject to a non-exclusive non-royalty bearing license, uses the patent in its business, depreciating it under I.R.C. § 167, transfers the patent along with all rights it ever received in the patent, and meets all other requirements of Rev. Rul. 78-328, the "sale or exchange" requirement will be met for purposes of I.R.C. § 1231. If, however, a taxpayer- transferor, itself, granted the outstanding license or retained rights of value, based on the AOD in Bell Intercontinental Corp. v. United States*,* 381 F.2d 1004 (1967), action on dec. 1967 WL 16240 (August 23, 1967), the sale or exchange requirement cannot be met and the transaction is a mere license for tax purposes.

[217] Protest, p. 31.

[218] See Protest, p. 33 ("This contention plainly fails to appreciate the distinction between **selling a patent - which Corporation A did not do in this case** - and selling a license interest in a patent - which is precisely what Corporation A did in this case.") (emphasis added).

Federal tax policy places a high value on tax law being in conformity with other federal laws.[219]

The Protest cites two cases as supporting it's assertion that tax law has evolved away from patent law relative to the sales of patents, Merck & Co. v. Smith, 261 F.2d 162 (3d Cir. 1958) and E.I. du Pont de Nemours and Co. v. U.S., 432 F.2d 1052 (3d Cir. 1970). However, neither Merck nor du Pont held that the Waterman Rule is no longer applied in tax cases, with the overwhelming majority of tax cases that apply the all substantial rights test applying the Waterman Rule (i.e., if the rights to make, use and sell are not transferred, even as to the transferor, the transfer is a mere license.) Moreover, importantly, in Merck the court stated that it must first consider whether the language in the agreement precluded the taxpayer from claiming that the transaction was more than a license.[220] Corporation A's agreements preclude it from claiming that the transaction was more than a license, as addressed in Law and Analysis § B, above.

Corporation A's reliance on Oak Mfg Co. is also misplaced because the case did not hold that tax law has evolved away from patent law. After framing the issue (whether the 1936 Agreement sold or licensed patents), the Oak Mfg court stated that "[t]o determine [the agreement's] legal effect, a somewhat detailed examination of the provisions of the [agreement] seems necessary." 301 F.2d at 260. Oak Mfg then specifically stated that the language of the agreement is relevant, notwithstanding the position in Merck. 301 F.2d at 261-2. The court noted that Merck is contrary to Commissioner v. Celanese, 140 F.2d 339 (D.C. Cir. 1944) and Commissioner v. Hopkinson 126 F.2d 406 (2nd Cir. 1942) – two cases that the Year 1 RAR, p. 38, pointed out were cited with approval by Congress as cases not within the safe harbor of I.R.C. § 1235, with Corporation A's case also outside of the § 1235 safe harbor. Oak Mfg ultimate found that:

> **[t]he terms of the agreement contemplated a continuing business relation in the nature of a franchise** for the distribution of Oak products in new markets. It was, in reality, the establishment of an agency relationship. **There was no intent to transfer the ownership of the patents. At most, Oak merely licensed** . . . **certain rights thereunder**.

301 F.2d at 262 (emphasis added).

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[219] See Chief Counsel Notice CC-2012-002, Whether Federal Common Law or State Law Governs Alter Ego Status, Tax Notes Today, December 2, 2011, 2011 TNT 235-14 (asserting a federal common law analysis is necessary for consistent tax policy to protect the important principle of uniformity of federal tax enforcement.). See also Rhone-Poulenc Agro v. DeKalb Genetics Corp., 284 F.3d 1323, 1334 (Fed. Cir. 2002) ("the Supreme Court has made clear that we must consider the purposes of federal statutes in framing a rule of federal common law, even if the statutes are not directly applicable.") (citations omitted).

[220] Merck, 261 F.2d at 164.

The court confirmed its ultimate finding by further finding, *inter alia*, that the agreement was not assignable without written permission, had a qualified right to sublicense, would only allow the licensee to sue for infringement in Oak's name, did not transfer the right to control infringement litigation, and the terms of the agreement indicated that "Oak considered itself to be the complete owner of the patents…." 301 F.2d at 263. The court also relied on the fact that "[t]he Supreme Court has said that the power to dispose of property is the 'equivalent of ownership.'" (citation omitted). 301 F.2d at 262. Thus, Oak Mfg does not stand for, or support, the Protest's position that tax law evolved away from applying the Waterman Rule in determining if a sale of an interest in a patent was effected. Rather, it supports the position of the Year 1 RAR that neither agreement can be treated as a sale agreement because neither agreement evidenced a clear and unmistakable intent to sell and, among other reasons, the terms of the agreement indicated Corporation B and Corporation A were the complete owners of their patents and Corporation A did not have the right to dispose of the Agreement C without permission from Corporation B.

The Protest then states Waterman is not a tax case.[221] The Year 1 RAR never claimed it was a tax case. The Year 1 RAR pointed out that multiple cases, both tax and patent, rely on Waterman as interpreting substantive law relative to what must be transferred to assign a patent, with the transfer of anything less a mere license. As Crown Die & Tool v. Nye Tool & Manufacturing Works, 261 U.S. 24, stated with respect to patents:

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

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

The Protest cites several other cases as supporting its position that tax law has evolved away from the Waterman Rule.[222] Significantly, the cited cases all deal with the sale of patents, not licenses; none of the cases establish that the Waterman Rule no longer applies. That is not surprising. Both patent and tax cases continue to apply the Waterman Rule and consider whether the parties intended to sell the assets being transferred. See Alfred E. Mann Foundation for Scientific Research v. Cochlear Corporation, 604 F.3d 1354, 1358-59 (Fed. Cir. 2010)("To determine whether an exclusive license is tantamount to an assignment, **we 'must ascertain the intention of**

[221] Protest, p. 32.

[222] Protest, p. 32, n. 134; p. 32, n. 136 and n. 139; Protest p. 33, n. 140.

the parties [to the license agreement] and examine the substance of **what was granted**.'")(citations omitted)(emphasis added).[223]

The protest also cited Green v. Commissioner, 83 T.C. 667 (1984), a tax shelter case, which asserts **Waterman is the source of the well established principle that the rights to make, use and sell must be transferred to sell a patent**. Green, 83 T.C. at 679. This cite, along with the rest of the opinion, does not state that tax law has evolved away from patent law. Rather, Green supports the Year 1 RAR in that Green rejected the taxpayers' claim to have intended to insert a condition precedent to the sale of the patents because the taxpayers failed to present sufficient evidence to overcome a motion for summary judgment in light of the fact the agreements unambiguously evidenced an intent to immediately transfer all three rights, and thus sell the patents. 83 T.C. at 681.

The Protest's quote from Liquid Paper Corp. v. United States, 2 Cl. Ct. 284, 290 (Cl. Ct.1983) is taken out of context and fails to take into account that the asset being transferred was a trade secret. The court explained that the government had lost three prior cases wherein it contended the agreement at issue was a license,[224] with Liquid Paper now contending the agreement was a license despite the cases finding it was a sale agreement. Liquid Paper argued the agreement was a license because it did not specifically state in the grant clause that Liquid Paper could use the trade secret that it purchased. The Protest-quoted language preceded the court's analysis of the missing word "use" and the court's finding that the grant clause in the agreement "impliedly included the right to use the formula." 2 Cl. Ct at 291. More critical to the opinion is the court's finding that Liquid Paper had failed to carry its burden to prove the mutual intent of the contracting parties was to license, not sell. 2 Cl. Ct. at 291-92. The court had stated at the beginning of the opinion that "a court must ascertain the mutual intention of the parties and then give effect to that intention, so long as it is consistent with legal principles." 2 Cl. Ct. at 290. Thus, Liquid Paper Corp. supports the Year 1 RAR's reliance on intent, but says nothing about whether tax cases have evolved away from applying the Waterman Rule for transactions transferring interests in patents.

The Protest relies heavily on Rollman v. Commissioner, 244 F.2d 634 (4th Cir. 1957), *rev'g*. 25 T.C. 481 (1955), *acq*. 1956-2 C.B. 4, 1956 WL 56488, (December 31, 1956). The reversed Tax Court opinion, which the Commissioner acquiesced in, held that that the agreement at issue did not sell the patent because all three rights required to be transferred by the Waterman Rule were not transferred. The Fourth Circuit looked to the terms of the agreement and found that "the intention of the parties to the agreement of December 19, 1940, to convey to Rikol the right to make full use of the patent is

[223] See also Law and Analysis, § B above (role of intent in tax cases and holding the taxpayer to the form of its agreement) and Exhibit Three, below (addressing patent cases applying the Waterman Rule).

[224] The prior cases involved the tax liabilities of the individual transferor, her ex-husband and her estate. The current case, 2 Cl. Ct. 284, involved the tax liabilities of the transferee, Liquid Paper.

clearly manifest." 244 F.2d at 639. The Fourth Circuit justified its finding that all three rights were transferred based on the intent of the parties by pointing out that "[n]o one in the pending case has ventured to suggest what use the Rollmans can make of the shoes manufactured under the patent other than to wear them; but this was a right to which every purchaser [of the shoes] was entitled to enjoy; . . . ." 244 F.2d at 639. The court rejected the Commissioner's argument the transfer at issue was subject to a prior license, pointing out that was an error of fact because the prior license did not relate to the patent at issue. 244 F.2d at 641.

Thus, Rollman does not provide support for an assertion that tax law has evolved away from the Waterman Rule because the Fourth Circuit found, as a matter of fact, based on the intention of the parties as expressed in the agreements, that all three rights had been transferred. However, Rollman does provide additional support for the position in the Year 1 RAR relative to the key role that intent plays in transfers of interests in patents.

The Protest also relies on Lockhart v. Commissioner, 258 F.2d 343 (3d Cir. 1958), which dealt with unsophisticated transferors. The opinion held that the income of the now deceased Mr. Lockhart was ordinary because he was in the business of selling his inventions, stating it was bound by the applicable law, although it sympathized with Mrs. Lockhart's view that this appeared unfair in light of the enactment of I.R.C. § 1235. 258 F.2d at 348. The Third Circuit then addressed the character of Mrs. Lockhart's income, since she co-owned some of the patents and was not in the business of selling patents. The Third Circuit stated that the omission of the word "use" from the informal letter agreement the widow and her husband had executed was not fatal when the agreement evidenced a clear intent to transfer all three rights, relying on Rollman.

The Protest also relies on Flanders v. United States, 172 F. Supp. 935, (N.D. Cal. 1959), another case involving an unsophisticated widow where the agreement did not specifically state the right to use was transferred, but this case was a § 1235 case. The court found the agreement ambiguous, and relied on extrinsic evidence of the parties' intent to sell all right title and interest in the patent. The court also relied on Rollman and Lockhart finding, based on the facts and circumstances of the case, that "[a]s a practical matter it cannot be said that the licensors reserved any substantial right of 'use'" and "the right of use by the licensee may be implied." 172 F. Supp at 949-50.

What Corporation A fails to take into account is that over the years many tax cases have cited, followed and/or distinguished Waterman;[225] but, never did tax

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[225] The case of Bell Intercontinental Corp. v. United States, and the AOD rejecting reliance on Bell Intercontinental, 381 F.2d 1004 (1967), *action on dec.* 1967 WL 16240 (August 23, 1967) were addressed at length in the Year 1 RAR, pp. 45-46 MacDonald v. Commissioner, 55 T.C. 840 (1971), *action on dec.* AOD 1972 WL 32827 (July 3,1972), *acq.* 1973-2 C.B. 2, and Rev. Rul. 78-328, 1978-2 C.B. 215 were addressed in the Year 1 RAR, with the Protest's interpretation of said case rejected in Law and Analysis, § C, above. None of these cited authorities support the claim that tax law has evolved to no longer apply the Waterman Rule.

law reject the Waterman interpretation that patent law requires that the rights to make, use and sell be transferred, with the transfer of anything less a mere license. In certain circumstances, cases find that a patent was sold because all three rights were, in fact, transferred based on the intent of the parties when the documents are ambiguous (typically an unsophisticated transferor) and when the right to use was implicitly transferred based on the facts of the case that establish the right to use had no value standing alone. These circumstances do not exist in this case. Corporation A is a sophisticated taxpayer and the agreements at issue are unambiguous licenses.

In addition, the cases cited by Corporation A rely heavily on the transferor's clear and unequivocal intent to sell, while Corporation A intended to license, not sell. Moreover, standing alone, Corporation A's retained right to use Corporation B's property has value, and cannot be equated with the right to wear a purchased pair of shoes, as in Rollman. Corporation A can use Corporation B's intellectual property in the Territory of the Agreement C as a platform and/or base for new inventions/discoveries that Corporation A can patent. See Year 1 RAR, Exhibit A, Time Line (

). See also Propat International Corp. v. Rpost, Inc., 473 F.3d 1187, 1190 (Fed Cir. 2007) (concurred that the District Court correctly decided all substantial rights were not transferred because, *inter alia*, **"the right granted . . . with respect to the invention is not exclusive, because [the transferor] retains the right to seek new patents on the underlying invention and therefore retains an implicit right to use the invention**.") (emphasis added). In addition to using Corporation B's patented

[226]

The Protest asserts C.A. Norgren Co. v. United States, 268 F. Supp. 816 (D. Colo. 1967), which decided a C corporation case by analogy to § 1235, supports its position. This case does not hold that tax law has evolved away from patent law. C.A. Norgren found a C corporation's retention of the right to grant additional license was not the retention of a significant right. This is just the type of right reservation that the action on decision in Bell Intercontinental rejected.[227]

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[226] Corporation C's role is addressed in the Year 1 RAR, Facts.

[227] Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (1967), *action on dec.* 1967 WL 16240 (August 23, 1967). See Year 1 RAR, pp. pp. 45-46. Cf. Abbott Laboratories v. Diamedix Corporation, 47 F.3d 1128 (Fed. Cir. 1995) (finding transferring a worldwide exclusive patent subject to pre-existing licenses does not assign the patent). C.A. Norgren is further addressed in Law and Analysis, § D.3, below.

The Protest also asserts that "Exam's repeated emphasis on the fact that Corporation H did not technically gain title to Corporation A's interest in Device A is simply irrelevant," citing to the Year 1 RAR, pages 33-43, as presenting the irrelevant arguments of technical title.[228] Those ten pages of the Year 1 RAR cannot be mistaken as addressing technicalities of title, much less repeatedly emphasizing such. The Year 1 RAR, pages 33-43, explained the Waterman Rule,[229] which is hornbook law on what must be transferred to avoid the transaction being a mere license. While Corporation A concedes it did not sell Corporation B's patents, those same pages of the Year 1 RAR (pages 33-43) addressed substantive tax cases such as Redler Conveyor Co. v. Commissioner, 303 F.2d 567 (1st Cir. 1962), which establish Corporation A's agreements cannot be treated as sale agreements because agreements that are clearly licenses cannot be recharacterized as sale agreements. Those ten pages also addressed the cases of Merck and du Pont, which Corporation A continues to rely upon in the Protest without even attempting to refute the Year 1 RAR position. Thus, the Protest errs in claiming Exam relied on technicalities of title.

Under Corporation A's theory, one person could own a patent or license, for patent purposes, and another person could own the patent, or license, for tax purposes. Corporation A has not cited any case that so holds for either tax law purposes or patent law purposes. Indeed, Corporation A cannot. Decisional tax law and decisional patent law are consistent, not in conflict.[230]

3. The Protest's Reliance on I.R.C. § 1235

The Protest relies on several I.R.C. § 1235 cases, arguing the cases are instructive for non-§ 1235 cases pursuant to language quoted from C.A. Norgren Co. v. United States, 268 F. Supp. 816 (D. Colo. 1967). Protest, p. 15, n. 61.

However, § 1235 cannot be applied to transfers by a C Corporation, such as the transfers at issue herein, because C corporations are not individuals, thus not holders for purposes of § 1235. I.R.C. § 1235(b). Congress specifically stated transfers of interests in patents for "corporations, is to be governed by the provisions of existing law

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[228] Protest, p. 32, n. 133.

[229] Waterman v. Mackenzie, 138 U.S. 252 (1891).

[230] Cf. Kremer v. Chemical Construction Corp., 456 U.S. 461, 468 (1982), quoting Radzanower v. Touche Ross & Co., 426 U.S. 148, 154, (1976)("whenever possible, statutes should be read consistently."). Further, if tax law were to evolve to be in conflict with federal patent, the balance Congress struck in its federal patent laws and the desired uniformity in treatment of patents would be destroyed. See Bonita Boats, Inc. v. Thunder Craft Boats, 489 U.S. 141, 162 (1989) ("One of the fundamental purposes behind the Patent and Copyright Clauses of the Constitution was to promote national uniformity in the realm of intellectual property."). See also Rhone-Poulenc Agro v. DeKalb Genetics Corp., 284 F.3d 1323, 1328 (Fed. Cir. 2002) (noting a situation when a federal rule "was necessary to avoid the possibility of a patent's being valid in one state and invalid in another state.").

as if this section had not been enacted." S. Rep. No. 83-1622, Committee on Finance, Detailed Technical Discussion at 441.

Treas. Reg. § 1.1235-1(b) reflects the intent of Congress by specifically providing (emphasis added):

> If a transfer is not one described in paragraph (a) of this section [certain transfers by holders], **section 1235 shall be disregarded** in determining whether or not such transfer is the sale or exchange of a capital asset.

Nowhere does the Protest cite a case that nullifies the provision in Treas. Reg. § 1235-1(b) that states § 1235 shall be disregarded in determining if an agreement, wherein a corporation transfers an interest in a patent, qualifies for capital gain treatment.

Nowhere does the Protest cite a case that establishes §1235 applies to transfers of <u>licenses</u> to use patents. Indeed, § 1235 cannot because §1235 does not apply to transfers of licenses or franchises. When § 1235 was enacted, the Committee on Finance clearly stated that § 1235 "does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent."[231]

To the extent that § 1235 is, nevertheless, instructive as to what patent law would provide for determining if there is a sale, Corporation A cannot pick and chose cases that do not reflect the law as set forth in the regulations promulgated pursuant to § 1235. For example (emphasis added):

- Treas. Reg. § 1.1235-2(b)(1)(iii) would not treat transactions where the transferor **retains a field of use** that had value at the time of the transfer as sales.

- Treas. Reg. § 1.1235-2(b)(1) would not treat transactions where the transferor **transferred less than all rights "whether or not then held"** by the transferor which had value at the time of the transfer as sales.

- Treas. Reg. § 1.1235-2(b)(2)(ii) would not consider a retention of rights that are <u>not</u> inconsistent with the passage of ownership such as mere security interests as precluding sale treatment, **but gives as examples of retention of security interests vendor's liens or "conditions subsequent" (such as provisions for forfeiture on account of nonperformance).**

To the extent § 1235 is instructive, neither Agreement A nor Agreement B could give rise to capital gains.

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[231] S. Rep. No. 83-1622, at 439 (1954).

- **Corporation A retained a field of use** , which has value. See Law and Analysis, § C, above (subsection addressing the retained).

- In Agreement C Corporation A granted Corporation B a non-exclusive, non-royalty bearing license in all of its know-how relative to Device A, Corporation A granted Corporation B a right of first refusal in all of Corporation A's future Improvements,[232] Agreement C, §§ ##, ## and ##. Thus, at the time of the execution of Agreement A and Agreement B, Corporation A had previously transferred to Corporation B valuable rights in all of Corporation A's know-how, patents, and intangible property the subject of the Agreement A. While Corporation B is to use these granted rights outside of the Territory, Corporation A transferred to Corporation H rights " ."[233] Thus, **Corporation A transferred less than all rights "whether or not then held,"** which had value.

- **Corporation A retained substantial rights** in the property the subject of Agreement A, such as the right to use the property licensed to it in Agreement C and many other substantial rights, as stated in the Year 1 RAR and confirmed in this memorandum. These retained rights are not just conditions subsequent and do not merely provide for forfeiture for non-performance.

The C.A. Norgren court, in addition to applying § 1235 by analogy to a C corporation transfer, stated it did not matter what rights the transferee received, all that matters is what rights the transferor retained. 268 F. Supp 816 at 821 (D. Colo. 1967). However, § 1235 cases look at what the transferor gave up, as well as what the transferor retained. This two-fold analysis was well articulated in Mros v. Commissioner, 493 F.2d 813, 816 (9th Cir. 1974),[234] a § 1235 case, when it adopted the test from the Sixth Circuit:

> The analysis suggested by the Sixth Circuit to determine whether the taxpayer is entitled to Section 1235 benefits is a two-fold test, outlined as follows: (1) What did the taxpayer actually *give up* by the transfer;

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[232] Agreement C § ## defines "Improvements" broadly. In essence

[233] Agreement A, § ## (emphasis added).

[234] Prior to the Ninth Circuit reversing the Tax Court decision in Mros, which was reported at T.C. Memo. 1971-123, the Commissioner recommended nonacquiescence and appeal, action on dec. 1971 WL 29567 (December 23, 1971). The action on decision stated, *inter alia,* that "As defined in Regs. section 1.1235-2(b)(1)(iii), 'all substantial rights to a patent' does not include rights granted, which are limited to certain fields of use and which are less than all rights covered by the patent."

> that is, was there an actual transfer of the monopoly rights in a patent; and (2) what did the taxpayer *retain* after the transfer; that is, are any substantial rights retained.

493 F.2d at 816 (emphasis in original).

To the extent § 1235 cases are instructive for determining if a license has been sold by a C corporation, applying this two-fold analysis to Corporation A's agreements, Corporation A cannot have sold Agreement C:

1. At most, what Corporation A actually gave up in Agreement A, as amended in Year 1, was the right to commercialize Device A in the Territory licensed to Corporation H . Corporation A never had the right to make Corporation B's Device A, so could not give up the right to make Corporation B's Device A.

2. What Corporation A retained included: (a) Corporation A's own patents and know-how; (b) the right to use Corporation B's patented Device A, and other intellectual and intangible property belonging to Corporation B; (c) ; and (d) many other rights, which in the aggregate are substantial, in addition to including rights which are *per se* substantial.

Accordingly, applying the two-fold test for § 1235 cases as adopted in Mros, Corporation A could not be treated as selling any patents and, if § 1235 was applicable to the transfer of a license to use a patent, could not be treated as selling Agreement C. At most Corporation A transferred a franchise to commercialize Device A in the Territory of Agreement A, with the income from transferring that franchise as ordinary, as found in the Year 1 RAR and further discussed in Law and Analysis, § E, below.

E. Corporation A Cannot Avoid Ordinary Income on the Franchise Transfer

At the outset, the Service maintains that I.R.C. § 1253, the provision enacted by Congress to specifically address the tax treatment of franchise, trademark and trade name transfers, mandates ordinary income treatment of all monies to be received by Corporation A from Corporation H under both the Agreement A and the Agreement B.[235]

[235] The Protest (p. 33) states that Exam asserts § 1253 only as an alternative argument if Agreement B constituted a sale. However, whether a franchise was transferred under Agreement A was addressed in Year 1 RAR pp, 50-53, with the conclusion that monies received under Agreement A were ordinary income because a franchise was transferred.

Section 1253 applies to a transfer of a franchise, whether the transfer is by sale or by license.[236] Accordingly, the Service's position is that, pursuant to § 1253, all of the income Corporation A received from Corporation H (under both Agreement A and Agreement B) is treated as ordinary income.

The royalty payments under Agreement A and Agreement B, as contingent payments based upon sales or purchases, constitute ordinary income to Corporation A in all events. I.R.C. § 1253(c). The Payment B and Payment A payments paid by Corporation H under Agreement A were ordinary income to Corporation A because a significant power, right, or continuing interest with respect to the subject matter of the franchise was retained. Finally, as to the lump-sum payment received in connection with Agreement B, the Service's primary argument is that the monies were an acceleration of the ordinary income to be received under Agreement A, and thus remain as ordinary income in the hands of Corporation A.[237] Alternatively, pursuant to § 1253(a), capital gain treatment would still be denied because a significant power, right, or continuing interest with respect to the subject matter of the franchise was retained.

Corporation A argues that § 1253 has no application to these transactions because the legislative history shows that Congress "sought to exempt transfers of interests in patents from the reach of § 1253."[238] Corporation A's position must be rejected for two reasons:

- It is an attempt to frame the transaction, and thus the tax issues, as involving nothing more than the transfer of an "interest in a patent," but that approach ignores the totality of the agreements and the business to be transacted; and

- Congress did not intend to exempt all transfers of interests in patents from § 1253, with the legislative history merely showing acknowledgment that consideration reasonably allocated to a patent transferred along with the transfer of a franchise, trademark and/or trade name, could receive capital gain treatment if the requirements of § 1235 were met as to that patent transfer.

1. Franchise Was Transferred; Consent to Use Patented Device A Ancillary

[236] Tomerlin Trust v. Commissioner, 87 T.C. 876, 887-888 (1986).

[237] See Law and Analysis, § A, above.

[238] Protest, p. 34. Corporation A has conceded that no patents were sold to Corporation H under either Agreement A or Agreement B. Corporation A characterizes the transactions as resulting in a transfer (by Corporation A) of "an *interest in* patent rights" (p. 29, italics added), or a transfer of all substantial rights Corporation A had as a licensee of a patent interest (p. 19), and explicitly states that Corporation A did not sell a patent, but rather sold a license interest in a patent (p. 33).

Significantly, Corporation A's assertion that § 1253 does not apply can only be sustained if the totality of the interests transferred to Corporation H is ignored. The commercialization agreement not only allowed Corporation H to sell
Device A, but included the transfer of the
to Corporation H, as well as additional intangible assets such as Corporation B and Corporation A know-how, the supply agreement for Device A, the development work/research results, etc. necessary to sell containing Device A
[239]

As defined by § 1253(b)(1), "the term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." The agreements at issue fit that definition, and the one asset actually placed in Corporation H's name is

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[241]

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[239] Corporation A attempts to focus attention solely on the license to use Corporation B's patent or its own patents to avoid the fact that, while § 1253 also looks to all facts and circumstances to determine whether what was retained is substantial, the statute also provides a list of powers, rights, and/or continuing interests, the retention of any one of which will result in a determination that the transferor has a retained a substantial right. Synscort Inc. v. United States, 31 Fed. Cl. 545, 550 (1994)(court to determine whether a transfer of a franchise is involved and if the franchisor retained significant rights as defined in § 1253(b)(2); court is not to perform its own analysis to measure the significance of those rights to determine whether retention amounted to "operational control" when the franchisor retains rights specifically listed in § 1253(b)(2)). Since powers, rights and/or continuing interests which are deemed to be substantial under § 1253 were retained, and because contingent payments were required under both Agreement A and Agreement B, Corporation A can only achieve capital gain treatment if it can avoid § 1253.

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[241] As discussed in the RAR, pp. 50-51, courts have noted that Congress provided an "expansive definition" of franchise to "include" agreements to sell or distribute goods within a specified area, which does not exclude other things otherwise within the meaning of a franchise. *See, e.g.*, Jefferson-Pilot Corp. v. Commissioner, 98 T.C. 435, 443 (1992), *aff'd* 995 F.2d 530 (4th Cir. 1993) (FCC licenses are agreements "between the Federal Government and the licensee, under which the licensee agrees to provide the service of radio broadcasting within a specified area in exchange for the right to broadcast"). *See also*, Jefferson-Pilot Corp. v. Commissioner, 995 F. 2d 530, 531 (4th Cir. 1993)("The definition of term 'franchise' is sufficiently broad to include licenses issued by the FCC.").

See also Exhibit One (

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[242]

a franchise, the payments made by Corporation H to Corporation A under Agreement A and Agreement B were ordinary income to Corporation A, pursuant to I.R.C. § 1253.

However, [243]

Therefore, since it is undeniable that permission from the patent-holder is also required before can be marketed in the U.S. prior to expiration of the patent, the question raised is whether the fact that the permission to was included in the commercialization agreement is somehow sufficient to make § 1253 inapplicable to the entire transaction.

Inclusion of the permission to use a in an agreement between private parties does not negate the fact that a franchise, , was was transferred from Corporation A to Corporation H. When another party holds a valid U.S. patent , there are two interrelated elements absolutely necessary before commercialization of

(2) consent of the patent holder to use and sale of the patented . While both elements are required, the relative significance and the permission to use another's patent is demonstrated by the simple observation that, while a factor may be necessary to achieve a certain end, said factor may not be sufficient, standing alone, to actually achieve the goal. Specifically, although Corporation A's license interest in Corporation B's patents allowed Corporation A to use Device A to , and thereafter would allow Corporation A to produce and sell Device A , said license interest in Corporation B's patents was not sufficient to allow Corporation A

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could be made

Therefore, before Corporation A could "monetize" the license interest it held in Corporation B's patents, it was necessary to secure Stated another way, while the interest in the patent was necessary to the endeavor, at least assuming a party's unwillingness to wait for patent expiration, the interest in the patent was not sufficient to allow commercialization
was an indispensible factor to commercialization.

[244]

[245]

2. Language of § 1253 Controls

[244]. When net sales exceeded $#### in , Corporation H was required to pay Corporation A Amount 9. When net sales exceeded $### in , Corporation H was required to pay Amount 9. Finally, when net sales exceeded $### in , Corporation H was required to pay ###. Agreement A, Article #.

[245] The royalty rate to be paid upon commercialization

Agreement A, Article #.

In addition to Corporation A's failure to acknowledge the totality of the interests transferred to Corporation A (initially) and then to Corporation H, Corporation A's position that § 1253 is inapplicable because legislative history shows that Congress intended to exempt patents from § 1253 treatment, is untenable for the following reasons:

- The language of § 1253(b)(1), which defines "franchise," is clear and is thus controlling;

- The legislative history of § 1253 does not support the proposition that the transfer of a franchise which includes the right to use patents is exempt from the reach of § 1253;

- Section 1235 is not applicable because Corporation A is a corporation and not a "holder" as defined in § 1235(b) and, when § 1235 is inapplicable, the proper tax treatment is to be determined under other provisions of the Code.[246]

a. Statutory Definition of Franchise is Clear

As stated above, under § 1253(b)(1), "the term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." The language of § 1253(b)(1) is clear and, since the statutory language is clear, it is conclusive unless there is a "clearly expressed legislative intent to the contrary."[247]

In Tele-Communications, the taxpayer claimed amortization deductions under § 1253(d)(2)(A) for the costs of acquiring several cable television franchises. The cable TV franchises were granted by a local government authority and were established by enacting an ordinance. The Service argued that amortization was not allowed under § 1253(d)(2)(A) because cable TV franchises were not contemplated by Congress when § 1253 was enacted; that Congress only intended to address 'business' franchises and not 'public' franchises. Accordingly, the Service argued that cable TV franchises should be excluded from § 1253.

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[246] Kershaw v. Commissioner, 34 T.C. 453, 455 (1960) (when § 1235 was found not to apply, tax consequences controlled by § 1239, of the 1954 Code, requiring ordinary income treatment for sale of depreciable property to a corporation more than 80% of which is owned by said person, spouse, minor children and minor grandchildren).

[247] Tele-Communications, Inc. v. Commissioner, 95 T.C. 495, 510 (1990), *aff'd* 12 F.3d 1005 (10th Cir. 1993), *acq. recommended* AOD 1996-05, 1996 WL 390084, *acq.* 1996-2 C.B. 1.

The Tax Court, identifying the issues as a “straightforward application of the principles of statutory construction,”[248] rejected the Service’s resort to legislative history because the statute itself was clear:

> In the instant case …Congress has provided a clear definition of the term ‘franchise.’ A franchise, for § 1253 purposes, includes (1) an agreement (2) which gives one of the parties the right to distribute, sell, or provide goods, services, or facilities (3) within a specified area. Sec. 1253(b)(1). …Satisfaction of the three elements of § 1253(b)(1) results in bringing a franchise within the purview of that § of the Code.

95 T.C. at 509.

Additionally, the Tax Court interpreted the § 1253(e) exclusion for the transfer of professional sport franchises as an indication that “Congress understood that the statute’s language cut a broad stroke," so that Congress included the exclusion in order “to limit [the statute’s] impact where it desired.”[249]

In Jefferson-Pilot Corp.,[250] the Tax Court applied the principles of statutory construction annunciated in Tele-Communications to hold that an FCC license is a franchise as defined in § 1253(b)(1). The Court of Appeals for the Fourth Circuit, affirming the Tax Court’s Jefferson-Pilot Corp. decision, agreed that the statutory definition of franchise was clear so that the role of the court was limited to applying the statute according to its terms.[251] Nevertheless, the appellate court also expressed its opinion that the legislative history provided little support for the government’s position:

> The Commissioner thoroughly canvassed the legislative history, but she found no express limitation of section 1253 to commercial franchises. The most that she could point to was Congress’s concern about the confusion over the taxation of commercial franchises. But this is too slim a reed to support the Commissioner’s argument that section 1253 pertains only to commercial franchises. The plain language of the statute precludes such a narrow interpretation.

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[248] 95 T.C. at 503.

[249] 95 T.C. at 510. Note that, while resort to legislative history was inappropriate, the Tax Court proceeded to examine the legislative history and found absolutely no support for the proposition that Congress intended to limit the kinds or types of franchises that were within the scope of § 1253 (other than for professional sport franchises, which were specifically excluded in the statute itself). 95 T.C 495, 511–514.

[250] Jefferson-Pilot Corp. v. Commissioner, 98 T.C. 435, 440-443 (1992), *aff’d* 995 F.2d 530 (4th Cir. 1993).

[251] 995 F.3d at 531.

995 F.2d at 532.

The agreement with Corporation A ( ) gave Corporation H the right to sell Device A within Country B. Since the three elements of § 1253(b)(1) are met, and there is no statutory exclusion of Device B commercialization agreements from § 1253, capital gain treatment is denied for the amounts received by Corporation A from Corporation H because contingent payments were to be made and, as to the non-contingent Payment B and Payment A payments, capital gain treatment is denied because significant powers, rights, or continuing interests were retained with respect to the franchise transferred to Corporation H.

b. Legislative History Does Not Support Corporation A's Position

A thorough canvass of § 1253's legislative history reveals no clearly expressed legislative intent that § 1253 will not apply to the transfer of a franchise (*i.e.,* agreement to sell a product in a specified territory) simply because permission to use a patented interest was also included as an integral part of the franchise agreement. (See Exhibit Four, Legislative History of I.R.C. § 1253 for a complete review of the official Congressional reports).

In fact, review of the legislative history supports the contrary proposition that § 1253 is clearly intended to apply to the transfer of a franchise even if permission to use a patent in the operation of the franchise is included as part of the agreement. The House Report addressed franchise agreements with the permission to use a patent, concluding that the income received for the transfer would be ordinary income:

> It has also been brought to your committee's attention that the typical franchise agreement does not transfer the total bundle of rights to a patent, trademark, or trade name, but only the right to the use of the particular item. Your committee does not regard the right of a franchise to merely use a patent, trademark, or trade name as the sale of a capital asset—such a right would appear to be only an incident of the underlying property. Rather, the transfer of the right to use a patent, trademark, or trade name does not appear distinguishable from a mere license, and compensation received by a franchisor for this limited right should properly be treated as ordinary income.[252]

3. <u>Significant Power, Right or Continuing Interest Retained</u>

Since Corporation A maintains that § 1253 is inapplicable, it has not stated any item(s) of disagreement regarding Exam's determinations regarding the significant powers and

[252] H.R. Rep. at 150, 1969 U.S.C.C.A.N. at 1815.

rights retained by Corporation A following both Agreement A [253] and Agreement B.[254] Therefore, in this Rebuttal it has been assumed that Corporation A is willing to concede that said determinations regarding the powers, rights or continuing interests retained by Corporation A are accurate. If Corporation A changes its position and advances any arguments intended to refute any of these determinations, Exam requests the positions to be reduced to writing and that Exam be provided an opportunity to address those new arguments.

F. Corporation A Cannot Use the Income Forecast Method

After review of the Protest, it remains Exam's position that, even if there was a sale, Corporation A did not properly report the sale and is not entitled to use the income forecast method. Additionally, Corporation A's assertion that it properly reported the sale to Corporation H as an installment sale in Year 1 cannot be upheld if the sale occurred in Year 5, as Corporation A now contends as its primary position.[255]

1. Factual background Re: Method of Accounting

Corporation A, Inc. did not report any portion of the Agreement A between it and Corporation H as a sale. Thus, there was no installment sale income stemming from the Agreement A reported on the taxpayer's income tax returns for the periods ended Date 13, Date 14, or the ended Date 15.

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[253] As detailed in Year 1 RAR, pp. 6-8, Corporation A could disapprove assignments, prescribe quality standards for the product and services (" "), require purchase of all Device A from Corporation A, preclude sale by Corporation H of directly competitive products, and had inspection and audit rights of manufacturing, testing, packaging and storage facilities. Corporation H was required to comply with the terms of the Agreement M between Corporation A and Corporation B. Net sales royalties were a substantial element under the agreement.

[254] As detailed in the RAR, pp. 16-18, Corporation A retained the right

Corporation A gave up its right

Corporation A still had the obligation to defend the patents from infringement claims. Corporation A remained obligated to perform under Agreement C with Corporation B. Corporation H was still required to obtain Device A from Corporation A, and pay Corporation A a supply royalty of ##%.

[255] Since Corporation A's income tax returns filed for the tax years ended Date 13, Date 14, Date 15, and Date 41, as well as the agreed to items in the closing agreements addressed in Section A, the RAR only addressed Corporation A's position that a sale to Corporation H occurred in Year 1. Now that Corporation A contends that the sale occurred in Year 5, additional grounds are available to support disallowance of the income forecast method as reported on the income tax return for Year 1.

Corporation A did report the Agreement B as an installment sale on its Year 1 income tax return, and deemed its remaining basis in what was sold to be Amount 12. Basis was calculated using Amount 13 paid to Corporation B pursuant to the Agreement C between Corporation A and Corporation B[256] as the beginning basis and subtracting Amount 14 in amortization.

Corporation A provided a workpaper entitled "Device A sale" that contained the taxpayer's calculation of the gain on its alleged sale of "Device A" in Year 1.[257]

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[256] On the workpaper, the payments to Corporation B were composed of an in the amount of Amount 26, of Amount 26, a of Amount 27 and a of Amount 28.

[257] Referencing the sale in this manner was consistent with line 1 of the Form 6252 (Installment Sale Income) included with the taxpayer's Year 1 income tax return, whereon the taxpayer listed "Device A" as its "Description of property" sold.

[258] Corporation A asserts the royalties payable after the first three years were paid for services so are excluded from the computation of gain. As found in the Year 1 RAR, and confirmed in Law and Analysis, § B, 2. above, and § F. 4, below, the on-going royalties are not being paid for services.

The workpaper also calculated interest under I.R.C. § 453A on the deferred tax liability from Corporation A's alleged installment sale. Corporation A reported $### in interest income on its Year 1 tax return; presumably the § 453A interest was included in this figure.

On a Form 4797 (Sales of Business Property) included with Corporation A's Year 1 tax return, the taxpayer reported a gain from a disposition of a "Device A License" in the amount of Amount 29, representing a gross sale price of Amount 21 and "Cost or other basis" of Amount 13, depreciation allowed or allowable of Amount 30 and adjusted basis of Amount 31. The Amount 30 was recaptured under I.R.C. § 1245 on lines 25 and 31 of the Form 4797.

Since the figures appearing on Corporation A's Year 1 tax return match (or, nearly match) those appearing on the workpaper that used the estimates of future royalties to determine a net profit on the alleged sale and to determine the profit percentage for purposes of reporting installment sale income, it appears that the taxpayer used the income forecast method to report its alleged sale, beginning in Year 1 and continuing in Year 6. The taxpayer did not attach any statements to its Year 1 tax return specifically stating an intention to elect the income forecast method; it simply used the method in deriving the amounts to report as installment sale income and I.R.C. § 1274 interest[259] on the return.

On its Year 6 tax return, Corporation A reported gain from installment sales (its alleged sale of the Device A license) in the amount of $####. This figure resulted from the product of royalties received during Year 6 ($######[260]) multiplied by a profit

[259] Assuming that Corporation A did report some I.R.C. § 1274 interest.

[260]

percentage of ####%.[261] The Year 1 workpaper had estimated Corporation A's Year 6 royalties from Corporation H as $#####.

2. Income forecast method

While Corporation A now argues that the sale to Corporation H occurred in Year 5, pursuant to the Agreement A, it asserts at page 35 of the Protest that it properly reported the proceeds received pursuant to the Agreement B as an installment sale under section 453, applying the income forecast method under the section 453 regulations.

The income forecast method enables a taxpayer to recover basis in property sold in a contingent payment transaction by prorating the basis against the income stream of the contingent payments. The basis recovered in any tax year equals the taxpayer's total basis in the property multiplied by the ratio of the contingent payment (exclusive of interest) received in the tax year to the total payments (exclusive of interest) that the taxpayer estimates will be received under the contingent payment agreement. Temp. Reg. § 15a.453-1(c)(6)(iii). This estimate of total payments is based on the conditions known to exist at the end of the tax year for which the income forecast method is first claimed—*i.e.*, at the end of the first year under the agreement in which a contingent payment installment is received. Temp. Reg. § 15a.453a-1(c)(6)(ii) & (iii).

a. Corporation A did not seek permission for a change in the method of accounting

A taxpayer is required to elect the income forecast method in the year it first receives payments on account of the alleged sale, which Corporation A now claims occurred as a result of the Agreement A. Thus, Corporation A was required to elect the income forecast method for this transaction for the tax year ended Date 13, the first year it received a payment from Corporation H. Instead, the taxpayer treated the payment from Corporation H in that year as royalties, and, thus, ordinary income.

If the switch from reporting the Agreement A income as ordinary income received from a licensing/sublicensing agreement (as reported on Corporation A's income tax returns for tax periods ended prior to the tax period ended Date 41), to reporting the income as proceeds from a contingent payment sale, with the taxpayer also electing to use income forecast method, constitutes a change in method of accounting, then Corporation A is not permitted to make that change since it failed to secure prior approval for the method change from the Commissioner.

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[261] The profit percentage that had been determined on the Year 1 workpaper was Amount ###%. There is no explanation for this change in percentage.

I.R.C. § 446 provides that taxable income shall be computed under the method of accounting the taxpayer regularly computes his income in keeping his books. The term “method of accounting” is not defined in the Internal Revenue Code or the Regulations. However, the term implies a set of rules under which a taxpayer determines when to include items of income and to deduct expenses in determining taxable income. A method of accounting includes not only the overall method of accounting (i.e., the cash receipts and disbursements method or the accrual method), but also the accounting treatment of material items. Treas. Reg. § 1.446-1(a)(1). A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a).

In order to be an accounting method, a practice must affect the time for including items in income or claiming deductions. Changes in method of accounting include a change from the cash receipts and disbursements method to the accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories, etc. Treas. Reg. § 1.446-1(e)(2)(ii)(a).

Treas. Reg. § 1.446-1(e)(2)(ii)(a) states that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for inclusion of the item or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(b).

In determining whether a practice involves the proper time for the inclusion of items in income or the taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over the taxpayer’s lifetime. If the accounting practice does not permanently affect the taxpayer’s lifetime taxable income, but does or could change the tax year in which taxable income is reported, it involves timing and is, therefore, considered a method of accounting. Rev. Proc. 97-27, 1997-1 C.B. 680; Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781 (11th Cir. 1984).

In the present case, Corporation A seeks to change from reporting the payments it received from Corporation H on account of Agreement a and Agreement B as ordinary royalty income from a license/sublicense[262], while depreciating its license from Corporation B, to reporting the payments as capital gain from the sale of an asset using the income forecast method. Rather than recovering its basis in the license it acquired from Corporation B through depreciation, Corporation A now seeks to recover it over the years Year 1 through Year 3 as basis in the asset(s) allegedly sold. Regardless of which method Corporation A uses, it will report the same amount of total income (i.e.,

[262] Again, Agreement A contained a sublicense of the rights Corporation A had under Agreement C with Corporation B, and a license from Corporation A of identified intangibles.

the gross receipts/purchase price minus the basis). Thus, its attempted recharacterization of the transaction involves a change in accounting method, and is impermissible without the prior consent of the Commissioner. I.R.C. § 446(e); see Treas. Reg. § 1.446-1(e)(3). Corporation A has not sought, nor received, such consent, and thus is not able to use the income forecast method to report the income from Agreement A, as modified by Agreement B.

The requirement of prior consent prevents distortions and inconsistencies in reporting and ensures that income does not get taxed twice or escape taxation altogether. Capital One Financial Corp. v. Commissioner, 659 F.3d 316 (4th Cir. 2001); see also Rankin v. Commissioner, 138 F.3d 1286, 1287 (9th Cir. 1998). Section 446(e)'s prerequisite of prior consent forecloses precisely what Corporation A attempts here -- it prevents "taxpayers from unilaterally amending their tax returns simply because they have discovered that a different method of accounting yields a lower tax liability than the method they originally chose." Diebold, Inc. v. United States, 891 F.2d 1579, 1583 (Fed. Cir. 1989).

Once a taxpayer has reported income according to a particular method, it must live with that choice—the taxpayer has made an election that is binding upon it and the Commissioner. Pacific Nat'l Co. v. Welch, 304 U.S. 191, 195 (1938). In the present case, Corporation A failed to request permission for a change in accounting method, and no approval has been granted by the Service. Thus, Corporation A is not permitted to use the income forecast method in Year 1.

b. If any property was sold in Year 1, it was not property eligible for the income forecast method

In the middle of page 36 of its Protest, Corporation A cites Treas. Reg. § 1.167(a)-14(c)(4) as support of its claim that the income forecast method can be applied to interests in patents. The Service does not disagree with this proposition, but disputes any claim that it is applicable in the present case. Corporation A did not sell an interest in a patent to Corporation H. If there was a sale, what was sold to Corporation H was a franchise.

The income forecast method for recovery of basis may be used where a contingent payment installment sale concerns types of property ordinarily eligible for depreciation using the income forecast method, or types of properties ordinarily eligible for cost depletion in which total future production must be estimated. Temp. Reg. § 15a.453a-1(c)(6)(i). The term "contingent payment sale" means 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 such sale or other disposition occurs. Temp. Reg. § 15a.453-1(c)(1).

For property placed into service after August 5,1997, I.R.C. § 167(g)(6) limits eligibility for use of the income forecast method for depreciation to (1) motion picture films and

videotapes and sound recordings, (2) copyrights, (3) books, (4) patents and (5) other property to be specified in regulations.

No additional property eligible for depreciation under the income forecast method has been added in regulations promulgated under I.R.C. § 167(g). However, mineral property, television films and taped television shows have been added to the list of property eligible for basis recovery under the income forecast method in a contingent payment installment sale under the installment sale regulations. Temp. Reg. § 15a.453a-1(c)(6)(ii). In addition, a temporary regulation gives the Internal Revenue Service the authority from time to time to specify other properties of a similar character which, in appropriate circumstances, will be eligible for recovery of basis on the income forecast method. Id. Also, a taxpayer may seek a ruling from the Service as to whether a specific property qualifies as property of a similar character eligible, in appropriate circumstances, for income forecast recovery of basis. Id.

However, I.R.C. § 167(g)(6) contains an exception for amortizable I.R.C. § 197 intangibles, which are not eligible for the income forecast method. A franchise is an I.R.C. § 197 intangible. I.R.C. § 197(d). Thus, a contingent payment installment sale of a franchise may not be reported under the income forecast method.

Additionally, the contingent payment under the installment agreement must be based upon receipts from, or units produced by, such depreciable or depletable property. Temp. Reg. § 15a.453a-1(c)(6)(i). The implication is that the payments must be akin to royalties—i.e., they must be based on sales of the acquired property, or be based on units produced by the acquired property. In the present case, some of the contingent payments are not based upon receipts from or units produced by such depreciable property. Agreement B requires Corporation H to pay Corporation A

The Internal Revenue Service acknowledges that, if Corporation A sold a license interest in a patent in an installment sale, it may be entitled to use the income forecast method to report the gain from such sale under Proposed Treas. Reg. § 1.167(n)-5(a), as the sale of an interest in a limited right in a patent. However, Corporation A did not sell its Agreement C from Corporation B. As argued in the alternative in the Year 1 RAR, the only "interest" that Corporation A could have 'sold' is the right to commercialize Device A

Such a transfer, if not a mere sublicense, is, at most, a transfer of franchise, with all income ordinary. See Year 1 RAR, Law and Analysis, Section C, pp. 50-59 ("If Corporation A did transfer any property under the Agreement B, the property transferred was a franchise under I.R.C. § 1253, pursuant to which

contingent and certain non-contingent payments received are treated as ordinary income.").

3. If there was a sale, basis is overstated

On page 35 of its protest, Corporation A asserts that its basis in what was allegedly sold to Corporation H was Amount 13, representing the entire amount Corporation A paid to Corporation B in Year 7 pursuant to the Agreement C between Corporation A and Corporation B. This figure would represent Corporation A's basis in what it subsequently sold to Corporation H only if Corporation A sold the Agreement C. As pointed out above, Corporation A did not sell the Agreement C to Corporation H in either Year 5 or Year 1. Thus, even if a court were to decide that a sale occurred, Corporation A has overstated its basis in whatever assets were sold, as stated in the Year 1 RAR, Law and Analysis, § E.

4. If there was a sale, recovery period is too short

Even if Corporation A were held to have sold an asset, and even if that asset is of a type eligible for reporting using the income forecast method, then Corporation A nonetheless has understated its income through its use of a basis recovery period of only three years after the year of sale.

Under income forecast method of depreciation, each year's depreciation deduction is equal to the cost (basis) of the property multiplied by a fraction. The numerator of the fraction is the current year's net income from the property, and the denominator is the total income anticipated from the property through the end of the tenth taxable year following the taxable year the property is placed into service. I.R.C. § 167(g)(1)(A). Use of the income forecast method similarly contemplates an eleven-year period for the recovery of basis.

In the last full paragraph on page 35 of its Protest, Corporation A erroneously claims that the final payment from Corporation H on account of Agreement B will occur in Year 3. This misstates the terms of Agreement B. Royalty payments from Corporation H to Corporation A continue after Year 3 for an indefinite period, as long as there are sales of the Device A under Agreement C with Corporation B. (See § ## and § ##, Agreement B). Sec. ## of Agreement B provides as follows:

(Emphasis added.)

This section shows that royalty payments from Corporation H to Corporation A are to continue in perpetuity after Date 8. Yet, Corporation A describes these payments as payments for services on page 37 of its Protest, claiming that these payments are unrelated to the sale of the assets it claims it sold in Year 5. A plain reading of the agreement as a whole shows that the reduced on-going royalties are part of the consideration Corporation H pays for the right to commercialize license products that it received. Alternatively, the ongoing royalties are being paid for supplies of Device A. The payments are in no way payments for labor—they are not measured by hours worked, but by the amount of Device A Moreover, Corporation A cannot provide parole evidence to rewrite the unambiguous contract terms to say that what the parties "really meant" to compensate with the ##% royalty was Corporation A's continued commitment to remain as a back-up manufacturer for Corporation H. The contract clearly provides that the ##% royalty is paid "**in consideration for the supply**" of the Device A acquired by Corporation A from Corporation B. The contemplated payments extend the duration of the basis recovery period beyond the three years asserted by Corporation A.

Even if a court were to conclude, contrary to the plain language of section ## of Agreement B, that the section provided for payments for services which were unrelated to Corporation A's sale of assets to Corporation H, section ## of Agreement B also provides for payments to Corporation A beyond the ###-year period argued by Corporation A. Sec. ## provides:

The plain language of this section does not limit the duration of Agreement B; like section ##, it contemplates payments from Corporation H to Corporation A for as long as Corporation A's relationship with Corporation B continues. These payments were part of the consideration for Corporation A's giving access to the Device A to Corporation H, and can not be separated from the remainder of the Year 1 transaction. The year of the final payment from Corporation H to Corporation A is unknown, depending on when payments for purchases of Device A cease. In its Protest, Corporation A does not address the payments provided for in sec. ## of Agreement B.

The duration of Agreement B is unlimited, and thus Corporation A's attempt to limit its basis recovery period to three years is untenable.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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

Please call at if you have any further questions.

Associate Area Counsel

By: ______________________________

(Large Business & International)

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Large Business & International Division

____

Large Business & International Division

Exhibit One

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Exhibit Two

The Six Factors Courts Apply to Determine if a Transfer of a Patent Interest Meets the Sale or Exchange Requirement of Tax Law

Based on a review of applicable case law, the Year 1 RAR categorized the general principles courts use to determine whether C corporations' agreements transferring interests in patents will be treated, for tax purposes, as selling either patents or a license to use patents. The general principles are stated as six factors that reflect the weight of authority for determining whether the transferred property interests are sold, or merely licensed or sublicensed.

The factors are phrased as issues to be evaluated, stating the general rules the courts apply for each principle of law addressed in each factor. The factors are ordered in the same order, explicitly or implicitly, that the issues are addressed in case law. The case law supporting each factor is set forth in the Year 1 RAR, with additional case support in the body of this memorandum.

The factors are summarized below, with the position of each party for each factor also summarized.

1. Factor One – Intent

Courts consider whether there was a clear and unmistakable intent, at the time of the transaction, to sell the patent or license. If the clear and unmistakable intent to sell is not present, the agreement is a license of the patent or a sublicense of the license, not an agreement that sells either the patent or the license. If the agreement evidences intent to license or sublicense, such intent negates intent to sell.

- Commissioner's Position: Corporation A lacked the requisite clear and unmistakable intent at the time of the transaction to sell the patents or know-how which are the subject of the agreements at issue, and also lacked the requisite intent to sell the Agreement C. Accordingly, none of Corporation A's agreements can be treated as selling patents, know-how, the Agreement C, or any part of the Agreement C.

- Corporation A's Position: Corporation A agrees that there must be a clear and unmistakable intent to sell at the time of the transfer. Corporation A does not agree the courts look to the plain words in the agreement to ascertain intent and/or argues the agreements manifested intent to sell, notwithstanding its concurrence that the agreements are, in form, licenses. See Factor Four, below (addressing agreements that are, in form, licenses).

2. Factor Two – One Cannot Sell What One Does Now Own

Courts consider whether the taxpayer owns the property it purports to sell. If the taxpayer does not own the property it purports to sell, the agreement cannot be treated as selling that property.

- Commissioner's Position: Corporation A never owned Corporation B's intellectual and intangible property, so it could not sell Corporation B's property. The Protest errs in asserting this factor was applied to argue a taxpayer cannot sell a license. While the Commissioner argued that Corporation A did not sell its license, *i.e.*, the Agreement C, the Commissioner never argued that a license cannot be sold. Specifically, Factor Two was not applied to support the position the Agreement C was not sold.[264] Rather, Factor Two was applied to Corporation A's prior position that it sold property belonging to another, *i.e.*, Corporation B's property, as opposed to selling Corporation A's license or Corporation A's patents.

- Corporation A's Position: Corporation A does not dispute that one cannot sell what one does not own. In the Protest, Corporation A no longer argues it sold Corporation B's property; rather, Corporation A argues it sold the Agreement C, in full or part. The Protest is internally contradictory as to whether Corporation A argues it sold its own patents and know-how.

3. Factor Three – Applicable Tax Doctrines

Courts consider whether applicable tax doctrines preclude sale treatment. For this case, Factor Three noted the substitute-for-ordinary income doctrine as an applicable tax doctrine.

- Commissioner's Position: The Agreement A is a license, with the Agreement B thereto merely accelerating ordinary income already due Corporation A. Accelerating ordinary income cannot change the character of the income. The Commissioner rejects Corporation A's claim that it mistakenly reported the Agreement A as a license. This position is contrary to Corporation A's prior representations, its tax returns, its agreements, the facts, and the applicable law.

- Corporation A's Position: Corporation A agrees the substitute-for-ordinary-income doctrine was correctly stated in the Year 1 RAR, but contends the Agreement A was a sale agreement. The Protest further contends that Corporation A mistakenly reported the Agreement A as a license agreement on its Year 5 tax return, and that the IRS cannot rely on Corporation A's

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[264] See Year 1 RAR, pp 31-32 (two paragraph application of Factor Two).

representations to the contrary, under penalties of perjury, on its tax returns or Corporation A's representations in the Year 10 closing agreement.

4. Factor Four – A Taxpayer Cannot Disavow Its Own Licenses

Courts preclude unambiguous license agreements from being altered by extrinsic evidence, but courts consider the question of whether an agreement is unambiguous to be a question of law. For tax purposes, if an agreement is unambiguous and, in form, a license, courts support and apply the tax doctrine that allows the Commissioner to hold a taxpayer to the license form of its agreement. A taxpayer faces an increased burden if it seeks to disavow the form it selected.

- Commissioner's Position: Corporation A's Agreement A, and the Agreement B thereto, are unambiguous, however, it is recognized that the question of whether an agreement is unambiguous is a question of law. The Agreements are clearly, in form, licenses based on the plain language within four corners of the agreements. As unambiguous license agreements, the Commissioner can, and does, hold Corporation A to the form of its agreements. The fact an agreement transfers patents or a license to use patents does not exempt the agreement from the well-established law allowing the Commissioner to hold a taxpayer to the form of its own agreements. Corporation A,

  [265] cannot introduce extrinsic evidence to change the form.

- Corporation A's Position: The Protest agrees that the Agreement A and the Agreement B are, in form, licenses. The Protest argues form does not matter if the agreement transfers interests in patents. The Protest argues substance over form, addressing Factor Four by cross reference to its arguments that only substance matters, using "substance" as a euphemism for retained rights, which are addressed in Factor Six.

5. Factor Five – Application of the Waterman Rule

When an agreement is ambiguous or is, in form, a sale agreement, courts will not treat the agreement as selling patents if the characteristics of the transaction are such that, applying the Waterman Rule,[266] the transaction would be a mere license.

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[265]

[266] Waterman v. MacKenzie, 138 U.S. 252, 255 (1891) (generally, exclusive right to make, use, and sale the patented invention, or an undivided part thereof, must be transferred for a sale, with a transfer of anything less a mere license). See, Exhibit Three, Patent Law Re: Assignments of Patents and Licenses to Use Patents.

- Commissioner's Position: Assuming, *arguendo*, Corporation A's agreements could be considered ambiguous (they are, in form, unambiguous licenses) and that Corporation A still contends it sold its own patents,[267] the characteristics of the transactions would have to be such that, in legal effect, the Waterman Rule would not treat the agreements as mere licenses of the patents. Contrary to Corporation A's arguments, decisional tax law has not evolved away from decisional patent law, nor does tax law conflict with patent law. Rather, patent and tax law are consistent, with both applying the Waterman Rule. With respect to Corporation A's position that it sold the Agreement C, the explicit terms of the Agreement C preclude the Agreement C from being assigned without the patentee's (Corporation B's) consent and the license is personal as to Corporation A. However, Corporation B did not consent to an assignment or a sale of its Agreement C to Corporation H, with the Agreement L that Corporation A relies upon only consenting to a sublicense. Thus, Corporation A cannot be treated as selling the Agreement C, which is consistent with patent law treatment of assignments of licenses, without the consent of the patent holder. In addition, as a general rule, a patent license is not divisible for sale purposes.[268] Accordingly, Corporation A cannot be treated as selling Corporation A's patents, and cannot be treated as selling the Agreement C, in full or part.

- Corporation A's Position: The Protest argues that tax law has evolved away from applying the Waterman Rule to determine if a patent is licensed or sold. Corporation A argues that the three rights the Waterman Rule requires be transferred (make, use and sell), even as to the transferor, do not need to be transferred because tax law no longer applies the patent law Waterman Rule. However, Corporation A may no longer contend it sold patents. With respect to Corporation A's position that it sold the Agreement C, in full or part, the Protest does not address the provision of the Agreement C from Corporation B that precludes Corporation A from assigning the Agreement C, in full or part, and does not dispute the cases cited in the Year 1 RAR relative to assignments of licenses. Rather, the Protest argues Corporation B's consent to sublicense constituted consent to assign, and that the Agreement C was not personal as to Corporation A so could be sold without consent.

6. Factor Six – Retained Rights

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[267] Corporation A no longer contends it sold Corporation B's patents. Corporation A did not sell its know-how; however, know-how is not separately addressed herein since the Year 1 RAR established Corporation A failed to transfer its know-how in perpetuity and, except for the requirement that know-how be transferred in perpetuity to be sold for tax purposes, know-how is treated like patents.

[268] Brush Electric Co. v. California Electric Light Co., 52 F. 945 (9th Cir. 1892). See Jan E. Lehman, Anne E. Melley and Elizabeth A. Brainard, Patents § XXXI Licenses, § D Transfer, 60 Am. Jur.2d Patents § 1060 (copyright 2011)("Even if assignable, a patent license is ordinarily assignable only in its entirety, and is not divisible.")(citations omitted).

Even if sale treatment is not precluded by any of the foregoing factors, courts will still not treat an agreement as selling patents if substantial rights are retained in the patents.

- Commissioner's Position: Corporation A retained substantial rights in all of its patents and know-how in the subject of the agreements, so could not have sold any of its patents or know-how. Corporation A also retained substantial rights in the Agreement C, with the rights Corporation A retained in the Agreement C permeating every aspect of the Agreement C. The rights retained in its patents and the Agreement C are substantial rights, not conditions subsequent in the nature of security interests. The Year 1 RAR listed rights that are considered *per se* substantial rights, which (if retained) preclude treating a patent as sold. Over two dozen of the retained rights in the Agreement A are set forth, in Law and Analysis § C, above. The rights that continue to be retained after the Year 1 Agreement are also set forth Law and Analysis § C, above. These retained rights include rights which are *per se* substantial rights, *e.g.*, Corporation A's retention of the right to use Corporation B's patented Device A, which was clearly exercised in that Corporation A continued to file patent applications for improvements using Corporation B's patented inventions. The retained rights included many rights which benefit Corporation A,

  The retained rights also included rights which gave Corporation A control of the activities of Corporation H. In addition to being substantial on a stand-alone basis, the retained rights are, in the aggregate, substantial rights and, as such, preclude sale treatment. Accordingly Corporation A cannot be treated as selling Corporation A's patents or the Agreement C, in full or part. At most, what Corporation A transferred was a franchise to commercialize licensed products. For the reasons stated in the Year 1RAR and Law and Analysis § E, above, the income from transferring the franchise is ordinary, whether or not the transfer is a license or a sale.

- Corporation A's Position: Corporation A concludes that all retained rights are mere security interests so they cannot be substantial rights. However, the Protest does not establish that all retained rights are conditions subsequent in the nature of security interests. Rather, the Protest appears to assume that, in the long run, every possible right that could be retained should be viewed as protecting the income stream from the licensed property, even if a *per se* substantial right and even if the rights allowed Corporation A to control the actions of Corporation H in commercializing . This position rejects the well-established principle that retention of rights such as those Corporation A retained preclude sale treatment.

Exhibit Three

Patent Law Re: Assignments of Patents and Licenses to Use Patents

1. Federal Patent Law and Assignments of Patents

The United States Constitution reserved to the federal government the power "[t]o promote the Progress of Science . . . , by securing for limited Times to . . . Inventors the exclusive Right to their . . . Discoveries[.]" U.S. Const. Art. 1, § 8, cl. 8. The federal government exercised this reserved power through the patent statutes, which are codified under Title 35 of the United States Code.

In the patent statutes, Congress struck a balance between encouraging inventions and benefitting the public. To encourage inventions, patentees are granted a statutorily-created monopoly, *i.e.*, the right to exclude all others from making, using or selling the invention without the permission of the patentee. See Year 1 RAR pp. 33-43 (further addressing the statutory monopoly). For the benefit of the public, the patentee must disclose its invention in order to obtain the statutorily-created monopoly,[269] and the invention must pass into the public domain when the patent term expires.[270]

Both the United States Supreme Court and the Federal Circuit have made it clear that the balance Congress struck in the federal patent statutes must be respected. Thus, state law that is contrary to federal patent law or violates federal patent policy is preempted.[271] Federal patent decisional law makes it clear that private parties cannot change federal patent law by contract.[272]

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[269] See 35 U.S.C. § 111(a)(2) and § 112 (disclosure requirement).

[270] See 35 U.S.C. § 154 (term).

[271] See, *e.g.*, Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470 (1974)(applied a three-factor analysis to evaluate if a state law conflicted with federal patent law by looking at whether (1) there is a conflict with the federal patent policy to encourage invention by granting, for the life of the patent, the patent owner the right to exclude others from making, using or selling the invention; (2) there is a conflict with the federal patent policy that a patentee must disclose its invention in order to obtain the right to exclude all others; and (3) there is a conflict with the federal patent policy that, when the patent expires, the invention is in the public domain). See also Sears Roebuck & Co. v. Stiffel Company, 376 U.S. 225, 231 (1964) ("Just as a state cannot encroach upon federal patent laws directly, it cannot, . . . [indirectly], give protection of a kind that clashes with the objectives of the federal patent laws."). The need to have uniform rules was considered so important that the application of the *bona fide* purchaser defense in a patent case was found to present a federal question due to the need for uniformity in Rhone-Poulenc Agro SA v. DeKalb Genetics Corp., 284 F.3d 1323, 1328 (Fed. Cir. 2002).

[272] See Scott Paper Co. v. Marcalus Mfg. Co., 326 U.S 249, 256-257 (1945) (commenting that private contracts cannot change federal patent law in deciding that the doctrine of estoppel could not be applied because the result would have, in effect, extended the patent for the invention at issue longer than allowed by Congress).

The fact that state law can be preempted if contrary to the balance struck by Congress, and the fact that private contracts cannot override federal patent policy, illustrates the critical importance of federal patent law.[273] The importance is further illustrated by the Congressional desire for uniformity in the treatment of patents, specifically conferring sole jurisdiction for patent appeals on the Federal Circuit just to promote consistency.[274]

The patent statutes specifically provide, *inter alia*, that "patents shall have the attributes of personal property . . . [and] . . . shall be assignable in law by an instrument in writing." 35 U.S.C. § 261. If an assignment of a patent is not recorded in the United States Patent and Trademark Office within three months of assignment, the assignment "shall be void against any subsequent purchaser . . . for a valuable consideration…." 35 U.S.C. § 261.

The patent statutes do not require a particular form be used to assign a patent. However, the landmark patent case of Waterman v. Mackenzie, 138 U.S. 252 (1891), sets forth what must be transferred for the transaction to rise to the level of an assignment of the patent.

> The patentee or his assigns may, by instrument in writing, assign, grant, and convey, either (1) the whole patent, comprising the **exclusive right to make, use, and vend** the invention throughout the United States; or (2) an undivided part or share of that exclusive right; or (3) the exclusive right under the patent within and throughout a specified part of the United States. A transfer of either of these three kinds of interests is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself, with a right to sue infringers. In the second case, jointly with the assignor. In the first and third cases, in the name of the assignee alone. **Any assignment or transfer, short of one of these, is a mere license**, giving the licensee no title in the patent, and no right to sue at law in his own name for an infringement.

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

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[273] While state laws that are contrary to federal policy can be preempted, "Supremacy Clause considerations do not come into play when a court balances competing federal rules." City of Kirkwood v. Union Elec. Co., 671 F.2d 1173, 1178-79 n. 14 (8th Cir. 1982), cert. denied, 459 U.S. 1170 (1983). **If there was a conflict between federal tax law and federal patent law, "[i]t is, of course, a cardinal principle of statutory construction that repeals by implication are not favored' ... and whenever possible, statutes should be read consistently**." Kremer v. Chemical Construction Corp., 456 U.S. 461, 468 (1982), quoting Radzanower v. Touche Ross & Co., 426 U.S. 148, 154, (1976); Porter v. United States Department of Justice, 717 F.2d 787, 797 (3d Cir.1983).

[274] "Congress conferred exclusive jurisdiction of all patent appeals on the Court of Appeals for the Federal Circuit, in order to 'provide nationwide uniformity in patent law.' H.R. Rep. No. 97-312, p. 20 (1981)." Bonito Boats v. Thunder Craft Boats, 489 U.S. 141, 162 (1989). Thus, Federal Circuit cases are particularly germane to ascertaining patent law.

These requirements that must be met so agreements are not mere licenses are referred to collectively as the Waterman Rule. See Year 1 RAR pp 34-41 (further describing and explaining the Waterman Rule). As explained in more detail in the Year 1 RAR, failure to transfer to the transferee the exclusive right, even as to the transferor, to make, use and sell the patented invention renders the transfer a mere license pursuant to Waterman.

Roche Products v. Bolar Pharmaceutical Co., 733 F.2d 858 (Fed. Cir. 1984), points out the patent act uses disjunctive language in providing a patentee with the right to sue anyone who makes, uses or sells the patentee's invention without permission in violation of federal patent law and policy, *i.e.*, it is an act of infringement if others make, use or sell a patented invention without permission. Roche stated "**[i]t is well established, in particular, that the use of a patented invention, without either manufacture or sale, is actionable**." 733 F.2d at 861 (citations omitted, emphasis added). Thus, Roche reconfirms the importance of the exclusive right to use, separate and apart from the rights to make and sell.[275]
Abbott Laboratories v. Diamedix Corporation, 47 F.3d 1128, 1130 (Fed. Cir. 1995),[276] reemphasizes that the federal patent act allows patent infringement actions to be

[275] Roche held that Bolar's use of Roche's patented active pharmaceutical ingredient (API) to develop a generic drug infringed Roche's patent even though Bolar had not commercialized a drug using the API. In 1984, after Roche was decided, an abbreviated process for approving generic drugs was established by the Drug Price Competition and Patent Term Restoration Act of 1984 (commonly known as the Hatch-Waxman Act), Pub. L. No. 98–417, 98 Stat. 1585 (1984) (codified as amended at 21 U.S.C. § 355 (2010) and 35 U.S.C. § 271(e)(2010)). Prior to the Hatch-Waxman Act, non-authorized generic equivalents of patented drugs could not be developed without infringing the patents that covered the drug, as exemplified by Roche. Under the 1984 revisions, the unauthorized use of a patented drug for the limited purpose of developing a generic drug no longer constitutes an act of infringement. The "safe harbor" from infringement terminates when an Abbreviated New Drug Application is submitted to the FDA for approval to market the generic drug prior to the expiration of the patents, as explained in Eli Lilly & Co. v. Medtronic, Inc., 496 U.S. 661 (1990). By this exemption/infringement regime, the Hatch-Waxman Act intended to accelerate the vetting of the validity of listed patents to accelerate the approval of generic drugs. However, if the patented drug, including patented API, is used for other purposes, such as to file patents on inventions developed through unauthorized use of the patented API, or the developed generic drug is commercialized prior to the patents being declared invalid or not infringed by the generic version of the patented drug, those acts would still constitute infringement.

[276] Abbott was relied upon in the Year 1 RAR, pp. 43 and 46.

brought by a patentee or its assigns, but that licensees generally lack standing to sue for infringement. In the context of applying the Waterman Rule, Abbott considered whether all substantial rights were transferred to determine if the transfer was an assignment, conferring standing, or a license.

Abbott listed other patent cases that found the retention of substantial rights precluded the transferee from being anything but a licensee, including: "*e.g.*, . . . Pfizer Inc. v. Elan Pharmaceutical Research Corp., 812 F. Supp. 1352, . . . , (D. Del. 1993)(**licensing owner retained**, *inter alia*, **right to market patented product**); Raber v. Pittway Corp. 23 USPQ2d 1313, 1314-15, 1992 WL 219016 (N.D.Cal. 1992)(**license subject to rights of prior licensees** and limits imposed on licensee's power of assignment), aff'd mem., 996 F.2d 318 (Fed. Cir. 1993); . . . ". 47 F.3d at 1132-33 (emphasis added).

More recent patent cases have also looked at retained rights in the context of applying the Waterman Rule. See Propat International Corp. v. Rpost, Inc., 473 F.3d 1187, 1190 (Fed Cir. 2007)(concurred that the District Court correctly **decided all substantial rights were not transferred** since**,** *inter alia***,** "the right granted to Propat with respect to the invention is not exclusive, **because [the transferor] retains the right to seek new patents on the underlying invention and therefore retains an implicit right to use the invention**.") (emphasis added).

Transfers that split the patent monopoly also cannot be treated as assigning the patent, in part; rather, such transfers are licenses. See, for example, Pope Manufacturing Co. v. Gormully & Jeffery Manufacturing Co. *et. al.*, 144 U.S. 248, 250 (1892)(opined a patentee cannot split up ownership of his patent into different parts by separately transferring claims under the patent to different persons).[277]

In addition, patent cases require intent to assign, and a look at what was granted, for a transfer of an interest in a patent to rise to the level of an assignment, rather than being a license. See Alfred E. Mann Foundation for Scientific Research v. Cochlear Corporation, 604 F.3d 1354, 1358-59 (Fed. Cir. 2010) ("To determine whether an exclusive license is tantamount to an assignment, **we 'must ascertain the intention of the parties [to the license agreement] and** examine the substance of **what was granted.'**")(citations omitted)(emphasis added).

Further, although Erie R.R. Co. v. Thompkins, 304 U.S. 64 (1938), importantly, found that federal courts lacked the authority to create general federal common law when hearing state law issues, recent case law has clarified the role of the federal courts regarding patent cases. In Rhone–Poulenc Agro, SA v. DeKalb Genetics Corp., 284 F.3d 1323 (Fed. Cir. 2002), the Federal Circuit deliberated on the Erie doctrine's application to patent cases, stating:

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[277] See also Year 1 RAR, pp. 43-44 (listing five rights, which if retained, would *per se* render the agreement a license, with supporting citations).

> The general rule, stated in Erie R. Co. v. Tompkins, 304 U.S. 64, 78 . . . (1938), is "there is no federal general common law." However, **in the area of patent law . . . "the [Erie] doctrine . . . is inapplicable** to those areas of judicial decision within which the policy of the law is so dominated by the sweep of federal statutes that legal relations which they affect must be deemed governed by federal law having its source in those statutes, rather than by local law." Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173, 176 . . . (1942).

284 F.3d at 1327, n. 1 (emphasis added).

Thus, the United States Constitution reserved to the federal government the right to grant and regulate patents. Pursuant to federal patent decisional law, failure to transfer the rights required to be transferred by the Waterman Rule results in the transfer of the patent being a mere license.

2. Federal Patent Law and Assignments of Patent Licenses

Unlike patents, patent licenses are not recorded in the United States Patent and Trademark Office, but can present a federal patent question if the license purports to abrogate or alter the balance struck by Congress in its federal patent policy. See Brulotte v. Thys, 379 U.S. 29, 32 (1964)("[Licenses] seldom rise to the level of a federal question. But **patents are in the federal domain**; and 'whatever the legal device employed' a projection of the patent monopoly after the patent expires is not enforceable….In light of those considerations, we conclude that a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se.*")(citations omitted)(emphasis added).

Another example of a license issue that can rise to the level of a federal patent question is the assignment of a license. See Year 1 RAR, pp 48-49 (the explicit consent of a patentee is necessary to assign a license, citing to Unarco Industries, Inc. v. Kelley Co., 465 F.2d 1303 (7th Cir. 1972); PPG Industries, Inc. v. Guardian Industries Corp., 597 F.2d 1090, 1093 (6th Cir.), cert. denied, 444 U.S. 930 (1979); and In re CFLC Inc., 89 F.3d 673 (9th Cir. 1996)).

In re Access Beyond Technologies, 237 B.R. 32, 45 (Bankr. D. Del. 1999), cited Unarco Industries with approval, paraphrasing the federal rule established therein and quoting In re CFLC, 174 B.R. 119, 123, (N.D. Cal. 1994), aff'd 89 F.3d 673 (9th Cir. 1996), as follows:

> This federal rule in favor of allowing a patent holder to choose who, if anyone, may use the patented invention promotes the important federal policy underlying patent law:

> to "foster and reward invention" [which] is primarily accomplished by granting a 17 year monopoly for the patent holder to exploit. Limiting assignability to licenses in which the patent holder expressly agrees to assignment aids the patent holder in exploiting the patent and thus "rewards" the patent holder. **Free assignability** of a nonexclusive patent license without the consent of the patent holder **is inconsistent with patent monopoly and thus inconsistent with federal policy**.

237 B.R. at 45 (emphasis added, citation omitted).

In re Access Beyond Technologies then stated:

> [W]e cannot conclude . . . that silence is express consent to the assignment, particularly where **federal law holds** the opposite: that silence, i.e., **lack of express agreement, means the agreement is not assignable.** As noted above, license agreements are personal to the licensee and not assignable unless expressly made so in the agreement....
>
> …[and this] has been the rule at least since 1852 when the Supreme Court decided Troy Iron & Nail v. Corning, 55 U.S. (14 How.) 193,…(1852)" PPG Industries Inc. v. Guardian Industries Corp., 597 F.2d 1090, 1093 (6th Cir.) cert denied, 444 U.S. 930 . . . (1979). Rather "express" authorization means just that – precise language granting, in black and white, the exact authority that is sought.

237 B.R. at 46.[278]

The status of federal patent law relative to assignments of nonexclusive licenses was recently summarized in a treatise as follows

> Federal policy precludes transfer of a nonexclusive license of a copyright or patent by the licensee unless the contract expressly provides that rights may be assigned or the licensor otherwise consents to the transfer.
>
> **The underlying theory for this rule originated with the proposition that a nonexclusive license is merely a promise to not sue the**

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[278] There are bankruptcy cases,
that have allowed a license to be assigned without the consent of the patentee in reliance on a state policy of assignability in bankruptcy proceedings, but those cases are against the weight of authority.

other party (the licensee). That promise is personal in nature and limited to the particular licensee; it cannot be transferred without consent. The nontransferability rule applies to nonexclusive patent and copyright licenses and comes with the force of federal policy, displacing state law. It precludes transfer without consent and also excludes the licensee's rights from being transferred to a bankruptcy liquidation estate.

Speaking with reference to a patent license, the Ninth Circuit provided an additional, modern explanation for the rule as to nonexclusive license contracts [citing to In re CFLC Inc., 89 F.3d 673, 679 (9th Cir. 1996), in the corresponding footnote]:

> The fundamental policy of the patent system is to encourage the creation and disclosure of new, useful, and non-obvious advances in technology and design by granting the inventor the reward of the exclusive right to practice the invention for a period of years. Allowing . . . states to allow free assignability of nonexclusive patent licenses would undermine the reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patent.

In effect, restricting transferability reflects the unique character of intellectual property: it is an asset that does not lose value or condition from mere use. Because of this, allowing the licensee to transfer rights under a license would allow the licensee to compete with its licensor on exactly the same work or product that the licensor offers. The policy that precludes this covers patent, copyright, and software license.

Raymond T. Nimmer and Jeff Dodd, Modern Licensing Law § 9:21 (updated October, 2011) (footnotes omitted)(emphasis added).[279]

Moreover, federal patent policy promotes inventions by granting the patent holder the right to exclude others from exploiting its patented invention without permission and both a non-exclusive licensee and an exclusive licensee may need the permission of

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[279] The law is not as clear with respect to exclusive licenses. See Alice Haemmerli, "Why Doctrine Matters: Patent and Copyright Licensing and the Meaning of Ownership in Federal Context," 30 Colum.J. L.& Arts 1, 22-24 (Fall 2006) (addressing exclusive as opposed to non-exclusive licenses).

the patentee to sell its license. To allow either to be sold without the permission of the patentee might violate the fundamental policy of federal patent law which rewards patentees with the power to exclude others from making, using, or selling the patentee's invention without the permission of the patentee. See Neil S. Hirshman, Michael G. Fatall, Peter M. Spingola, "Is Silence Really Golden? Assumption and Assignment of Intellectual Property Licenses in Bankruptcy" 3 Hastings Bus. L.J. 197, 199-206 (Spring 2007)[280] (analyzed In re Hernandez, 285 B.R. 435, 439 (Bankr. D. Ariz. 2002), and argued that cases which allow assignment without the express consent of the patentee are cases wherein the court has construed the agreement at issue to find "such license would not be considered a license but rather an assignment, and the [licensee is actually] the owner of [the] patent [with] an unrestricted right to assign."); David I. Cisar, "Exclusive and Non-exclusive IP Licenses and Executory Contract Assumption and Assignment: Does Exclusivity Matter?" Am. Bankr. Inst J. 28, 29 (February 2003) (evaluating the evolution of the law and citing to In re Hernandez as finding just because a patent license may vest the licensee with standing to sue . . . [that] does not mean the license is assignable).[281]

Even if the rule precluding license assignments without the patentee's consent applied only to nonexclusive licenses, consent would still be needed if the license is personal in nature. See Margaret M. Lee, Patents, 82 N.Y. Jur. 2d Patents § 21 (updated November

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In addition, as a general rule, licenses are not divisible for sale purposes. See Jan E. Lehman, Anne E. Melley and Elizabeth A. Brainard, Patents, § XXXI Licenses, § D Transfer, 60 Am. Jur. 2d patents § 1060 (copyright 2011) ("**Even if assignable, a patent license is ordinarily assignable only in its entirety, and is not divisible**.")(emphasis added, citations omitted).

[280] This article addresses copyright patent, trademark, computer software, know-how licenses and bankruptcy issues separately.

[281] The article discusses both copyright and patent licenses, with copyright law distinct from patent law, albeit the retention of the federal government power to legislate in both areas is derived from the U.S. Const. Art. 1 §8, cl. 8 (the Patent and Copyright Clause). See Alice Haemmerli, "Why Doctrine Matters: Patent and Copyright Licensing and the Meaning of Ownership in Federal Context," 30 Colum. J.L. & Arts 1 (Fall 2006) (more extensive discussion of the difference between federal patent and copyright laws).

[282]

Treatises that discuss the non-divisibility rule generally cite to the case of Brush Electric Co. v. California Electric Light Co., 52 F. 945 (9th Cir. 1892).[283] Brush Electric Co involved an exclusive license to use and sell, but not make. The exclusive licensee in Brush Electric Co sought to sue an infringer in the name of the patentee and the patentee objected. The patentee argued that it could not be a plaintiff against its will, that its licensee had no interest in the suit since the licensee had assigned the license, in relevant part, to another, and that the licensee had no right to divide the license.

The Ninth Circuit disposed of the unwilling plaintiff argument by rejecting a right without a remedy in reliance on precedent that, in certain circumstances, gave an exclusive licensee standing to sue for infringement, *e.g.*, the patentee was the infringer. For the latter two allegations of the patentee, the Brush Electric Co Court found the two contentions contradictory. Relying on the general rule a license is not divisible to invalidate the assignment of part of the license and construing the license as not providing that it had been forfeited by the invalid attempt to assign, the court found the exclusive licensee could join the patentee as a co-plaintiff against its will.

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[283] The rule that licenses are generally not divisible for sale purposes may have originated in the early 1800s, as can be derived from Brooks v. Byam, 4 F. Cas. 261 (C.C.D. Mass. 1843), the case cited for the rule by Brush Electric Co. The Brooks court found that divisibility of licenses would hurt patentees, stating

> "[i]t exposes the patentee to the competition of . . . different distinct persons, acting in severalty, and independently of each other. It may make an essential difference to the patentee in his own sales, whether the whole of the right or privilege granted to [the licensee] be in the possession of one, or more persons, having a joint interest, and of several persons, each having a separate and independent interest. The danger too [sic] the patentee of an abuse or excess of the right or privilege granted by him is materially enhanced by the circumstance, that each of the sub-holders may be acting at different places at the same time, and the nature and extent of their claim and use of the right or privilege may be difficult for him to ascertain and leave him without any adequate remedy for any such excess or abuse of it."

4 F. Cas at 268.

After reviewing many historical cases and treatises and finding the license at issue was ambiguous (acknowledging if the intent of the parties was clearly not to divide, then the license could not be divided), the Brooks court pointed out that

> [the licensee] "might well sell to any person or persons all or any undivided portion of the matches made by him under his license; but that would be a very different thing from a sale of a fraction of the privilege to make them.

4 F. Cas at 270.

The court then opined "the license [is] an entirety, and incapable of division, or of being broken up into fragments in the possession of different persons . . . . [I]f it be assignable, [the] assignment must be of the entirety of the license to the assignee, and it cannot be apportioned among different persons in severalty." 4 F. Cas. at 271. The court denied equitable relief to the plaintiff because it had no right to exercise a right that was never assignable to him.

Thus, if a licensee retains part of the license, the transaction transferring the other part(s) will still be a sublicense since one cannot indirectly encroach on the patentee's right to exclude when it cannot do it directly,[284] and a license is not divisible for sale purposes.

[284] Cf. Sears Roebuck Co.v. Stiffel Co., 376 U.S. 225, 231 (1964) (so stating with respect to state law).

Exhibit Four

Legislative History of I.R.C. § 1253

Section 1253

Section 1253 (a) provides:

> GENERAL RULE. - A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

House Report 91-413[285]

As set forth in the House Report, Section 1253 was enacted to address two significant problems stemming from the substantial growth in franchising in the United States. First, it was difficult to determine whether there was a sale or a license, with courts reaching disparate conclusions based upon assessment of retained rights under each franchise agreement and, as to some jurisdictions, how the payments were to be made by the franchisee upon transfer of the franchise. Second, the courts were not sufficiently exploring whether the franchisor was selling franchises in the ordinary course of its business.

Noting that the general capital gain provisions under the Code, as well as under § 1235 relating to the transfer of patent rights, were supposed to be available only if the transferor relinquished all substantial control over the property, the House reasoned that a new Code provision was necessary to address the problems related to the transfer of franchises. In other words, since some franchisers retained significant rights and, in some cases, participated substantially in the operation of the franchisee's business, income the franchisor received from the franchisee should be denied capital gain treatment.

The House Report specifically addressed the effect of an interest in a patent being included with the transferred franchise, and it does not support Corporation A's premise that § 1253 would not be applicable in such a situation:

> It has also been brought to your committee's attention that the typical franchise agreement does not transfer the total bundle of rights to a patent, trademark, or trade name, but only the right to the use of the particular item. Your committee does not regard the right of a franchise to merely use a patent, trademark, or trade name as the sale of a capital

[285] H.R. Rep. 91-413, H.R. Rep. No. 413, 91st Cong., 1st Sess. 1969, 1969 U.S.C.C.A.N. 1645, 1969 WL 5895 (Leg.Hist.) (August 2, 1969).

> asset—such a right would appear to be only an incident of the underlying property. Rather, the transfer of the right to use a patent, trademark, or trade name does not appear distinguishable from a mere license, and compensation received by a franchisor for this limited right should properly be treated as ordinary income.[286]

The House version of what would eventually become § 1253 included the general rule that capital gain treatment would be denied as to transfers of franchises in which any significant power, right, or continuing interest was retained. The House version also contained an exception to the general rule, providing that the general rule would not apply:

> with respect to amounts received or accrued, in connection with a transfer of a franchise, which are attributable to the transfer of all substantial rights to a patent, trade-mark, or trade name (or the transfer of an undivided interest therein which includes part of all such rights), to the extent the amounts are separately identified and are reasonable in amount. These amounts, as is the case with a transfer of a patent under section 1235, would be entitled to capital gains treatment.[287]

In other words, the House initially intended to pass a regime that would allow capital gain treatment for a portion of the consideration received in connection with the transfer of a franchise, even when the franchisor retained a significant power, right, or continuing interest in the subject matter of the franchise, if there was a reasonable allocation of the consideration received to a trade-mark, trade name, and/or patent clearly transferred to the franchisee as part of the transfer of the franchise, and if all substantial rights in the patent were transferred. In spite of the House's willingness, under certain circumstances, to allow capital gain treatment for a portion of the consideration received in connection with the transfer of a franchise with a retained interest, the House also included a specific caution against interpreting the proposed exception too broadly:

> However, this exception is not to be construed to mean that the right of a franchisee to merely use a patent, trademark, or trade name is the sale of a capital asset. Rather, **the transfer of the right to use a patent, trademark, or trade name would be a license**, and compensation received by the franchisor for this limited right should properly be treated as ordinary income.[288]

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[286] H.R. Rep. at 150, 1969 U.S.C.C.A.N. at 1815.

[287] H.R. Rep. at 152, 1969 U.S.C.C.A.N. at 1817.

[288] Id. (emphasis added).

Senate Report 91-552[289]

The Senate Report described the same problems identified by the House (i.e., sale versus license, capital item or transferred in ordinary course), and also identified the problem that franchisees faced trying to claim depreciation or amortization deductions of acquisition fees because the assets were considered to be intangible with unascertainable useful lives.

The Committee on Finance agreed with the House that a new Code provision was required, but included the following revisions:

1. Extended the House's provision by treating the transfer of trademarks and trade names in the same manner as the transfer of franchises;

2. While including the two items that the House identified as constituting a significant power, right, or continuing interest, articulated four additional items as a significant power, right or continuing interest;

3. Provided that all amounts contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred were to be treated as ordinary income by the transferor, and were deductible as trade and business expenses by the transferee;

4. Provided that treatment of initial payments made by the transferee (whether lump-sum or fixed amount payable in installments) depended upon whether the transfer would be treated as a sale or a license under the provision (if sale, not amortizable if no useful life; if not a sale under the new provision, then amortize the initial payments over the period of the agreement but, in no event, over more than ten taxable years[290]);

5. Expanded the concept of "franchise" to one that "includes" an agreement giving one of the parties the right to sell goods within a specified area, rather than "being" such an agreement[291]; and

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[289] S. REP. 91-552, S. Rep. No. 552, 91st Cong., 1st Sess. 1969, 1969 U.S.C.C.A.N. 2027, 1969 WL 5896 (Leg. Hist.) (November 21, 1969).

[290] Significantly, the Committee would permit a transferee to elect to deduct the payments under the new rules if the transfer occurred before the effective date of the new provision, but "only if the transaction were treated for tax purposes as a license rather than a sale from the transferor's standpoint." S. Rep. 91-552 at 200, 1969 U.S.C.C.A.N. at 2245. Accordingly, this shows an intent for consistent treatment as to the type of income received by the transferor and the type of deduction allowed to the transferee.

[291] This distinction was one of the reasons cited for rejecting a taxpayer's argument that § 1253 only applied to the narrow or naked right to distribute or sell goods within a specified area and did not apply to determine the tax treatment for other tangible and intangible assets transferred along with franchise transfer. Syncsort Inc. v. United States, 31 Fed.Cl. 545, 550-551 (1994).

6. Excluded professional sport franchises.

Since the amendments to the House bill did not include the House's recommended exception for patents, trademarks, and trade names, it is clear that the Senate did not agree with the House view that transfers of trademarks or trade names should receive capital gain treatment even if the transferor retained a significant power, right or continuing interest. There was no discussion in the Senate Report, however, as the House's proposed exclusion for the transfer of patents.

Conf. Rep. 91-782[292]

The Conference Report states that the conference substitute that was adopted followed the Senate amendments, with the conferees describing the Senate amendment as making "more specific the rules of the House bill and extend[ing] these rules to trademarks and trade names."[293] No mention of transfers of interests in patents was made in the Conference Report.

Committee Prints

The only reference we were able to locate in the legislative history regarding the failure to include the House bill's exclusion for the transfer of patents in the final bill was the reference quoted in the Protest:

> The rule provided by the House version of the bill would not apply with respect to amount received or accrued in connection with the transfer of a franchise which is attributable to the transfer of all substantial rights of a patent, trademark, or trade name, to the extent the amounts separately identified are reasonable in amount. The committee amendments, however, deleted these exceptions, since patents are treated specifically in section 1235 of the code and the committee amendments also apply the general franchise rules to transfers of trademarks and trade names.[294]

This statement, particularly read in context with the official Congressional Reports, does not show Congressional intent to exclude from treatment under § 1253 transfers which

[292] CONF. REP. 91-782, Conf. Rep. No. 782, 91st Cong., 1st Sess. 1969, 1969 U.S.C.C.A.N. 2391, 1969 WL 5897 (Leg. History) (December 22, 1969).

[293] Conf. Rep. 91-782 at 42, 1969 U.S.C.C.A.N. at 2434. The conference language differed from the Senate amendments by adding a restriction limiting a transferee's ability to deduct contingent payments, with respect to transfers made before the effective date, to contingent payments made after 12/31/1969 and before 1/1/1980.

[294] Staff of the Joint Comm. on Internal Revenue Taxation, 91st Cong., 1st Sess., Summary of H.R. 13270, Tax Reform Act of 1969, 82 (Comm. Print Nov. 18, 1969)(as reported by the Committee on Finance).

consist of agreements giving the transferee/franchisee the right to sell a product within a specified area (i.e., franchise transfers) simply because the agreement also includes permission to use or

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