CAPITAL CONTRIBUTIONS OF LIMITED LICENSE RIGHTS TO INTELLECTUAL PROPERTY UNDER § 351

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ABSTRACT

The article examines what the law is and should be with respect to the domestic transfers of intellectual property license rights in a transaction intended to come within § 351. The article's objective is to answer the question as to whether the phrase "property is transferred," as used in § 351(a), does and should encompass limited license rights to intellectual property. The article argues that the Internal Revenue Service's pronouncements requiring that "all substantial rights be transferred" and the transfer constitute "a sale or exchange" pursuant to § 1222, is a blatantly inappropriate standard for determining whether the § 351 requirement that "property is transferred to a corporation" has been met. Aside from the different language used in § 351(a) (and § 721(a)) from that of § 1222, the purposes of the provisions are vastly different. As the Court of Claims observed in E.I. du Pont de Nemours & Co. v. United States, *there is a "great variance between the purposes of § 351 and of the capital gains sections, and by the clear irrelevance of the concepts from the latter . . . to the goals and theory of the former." Even if the Internal Revenue Service is giving benign neglect to their earlier pronouncements in this area, by not aggressively challenging on audit § 351 capital contributions of intellectual property licenses, absent a statutory fix, the Internal Revenue Service's modification of prior administrative guidance to be consistent with DuPont would be harmonious with sound tax policy.*

I. INTRODUCTION

Intellectual property has been characterized as "the measure of wealth in the modern worldwide economy."[1] This article examines what the law is and should be with respect to domestic transfers (i.e., between U.S. residents) of intellectual property license rights in transactions covered by I.R.C. § 351. This article's objective is to answer the question as to whether the phrase "property is transferred," as used in § 351(a), does and should encompass limited license rights to intellectual property.[2]

It should be noted at the onset that the term "property" is used in both §§ 351 and 1221.[3] However, some important court decisions have held that the transfer of an intellectual property license right falls within the parameters of § 351, despite the fact that if such right were sold to a third party it may not receive capital gain treatment as the "sale or exchange"[4] of a "capital asset."[5] Nevertheless, the Internal Revenue Service (the Service), in public pronouncements, has rejected this dichotomy of treatment.

Consider the following hypothetical: Corporations A, B, and C decide to form a corporate joint venture, Newco, to manufacture and market a patented drug formulation whose main benefit is to delay the onset of Alzheimer's disease. The parties also intend for Newco to develop other pharmaceuticals in the future. B and C each contribute $1 billion to help fund manufacturing, distribution, future research and development, and other initial costs of the operations. Newco is a C corporation. The parties choose this form for the joint venture because they expect to raise additional capital in the short term by having Newco issue additional shares that will be publicly traded. A contributes all its patent rights on this drug formulation for a period of ten years (assume the patent has a legal life left of fifteen years). A retains all rights to the patent after the expiration of the ten years. Now, consider as an alternative: A transfers the patent rights for the remaining fifteen years,

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1. Harsha Reddy, *Intellectual Property: Exploitation and Disposition*, Portfolio 558-2nd (BNA), Detailed Analysis, A. Analytical Framework.
2. I.R.C. § 351(a) (Westlaw through Pub. L. No. 115-281).
3. *Id.* § 351(a); 1221(a).
4. *See generally id.* § 1222 (defining long-term and short-term capital gains and losses).
5. *Id.* § 1221(a).

but A retains its field-of-use patent rights with respect to the formula's successful ability to diminish the effects of arthritis.[6] Should A's realized gain on the transfer go unrecognized by virtue of § 351 in either or both of these scenarios? This article will discuss the case law, the Service's position, and what the law should be in similar situations.

As part of this analysis, the article also examines capital gain versus ordinary income characterization of sales to third parties. For example, instead of forming a joint venture with B and C, assume A transfers the right to use the patent for ten years to a third party for cash consideration. Alternatively, what if the assignment was for fifteen years, but A retained the patent rights with respect to arthritis?[7]

II. THE POSITION OF THE COURTS AND THE SERVICE REGARDING THE SCOPE OF "PROPERTY IS TRANSFERRED" IN § 351

A. The Scope of "Property is Transferred" in § 351 According to the Service's Pronouncements

Section 351(a) states that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."[8] In Revenue Ruling 64-56, the Service held that unpatented technical know-how is property for purposes of § 351.[9] The Service, however, signaled in the same ruling that § 351 would not cover transfers of limited rights to know-how except to the extent the restrictions relate to entire countries.[10] Thus,

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6. This assumes the patent covers the compound per se or it covers the compound and its use with respect to both treating Alzheimer's disease and the symptoms of arthritis. As this writer understands it, the patent could have alternatively been limited to a method for treating Alzheimer's disease and not covered its use with respect to arthritis.

7. Assuming A is a C corporation, it would generally be indifferent to whether a transaction results in capital gain or ordinary income, although capital gain characterization could be beneficial if the C corporation had current capital losses or capital losses during the three-year carryback or five-year carryforward periods. *See* I.R.C. §§ 1211(a), 1212(a) (Westlaw). Another major advantage to sale treatment is the recovery of basis, which could be relevant if the intellectual property being divested is not self-developed. Even if self-developed, the taxpayer may not have elected to deduct its research and experimental expenditures pursuant to § 174. Furthermore, commencing in 2022, pursuant to a change to § 174 made by P.L. 115-97, § 13206(a), domestic research and experimentation expenditures will need to be capitalized and amortized. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, 2111–13 (2017) (modifying 26 U.S.C. § 174 and explaining accounting method changes under the Internal Revenue Code).

8. I.R.C. § 351(a) (Westlaw).

9. Rev. Rul. 64-56, 1964-1 C.B. 133, *amplified by* Rev. Rul. 71-564, 1971-2 C.B. 179.

10. Suresh T. Advani points out that Rev. Rul. 64-56 "does not state that an incomplete transfer [i.e., the transferor retains substantial rights] will not qualify under Code Sec. 351, but has been read by many, including the IRS, as implying as much." Suresh T. Advani, *Characterizing the*

the requirement that "property is transferred" in § 351 is satisfied where the transferor contributes all of its rights to use the know-how in country A, even though the transferor retains the rights to use the know-how in country B.[11] The ruling provided in pertinent part: "The transfer of *all substantial rights in property* of the kind hereinbefore specified will be treated as a transfer of property for purposes of section 351 of the Code."[12] Thus, a nonexclusive right to use the know-how would not suffice.[13] Moreover, the ruling pointed out "where the information transferred has been developed specially for the transferee, the stock received in exchange for it may be treated as payment for services rendered."[14]

The Service's position on the meaning of "property is transferred" with respect to intellectual property was further clarified in Revenue Ruling 69-156.[15] The ruling held that:

> [t]he grant of patent rights to a corporation will constitute a transfer of property within the meaning of section 351 of the Code only if the grant of these rights in a transaction which would ordinarily be taxable, would constitute a sale or exchange of property rather than a license for purposes of determining gain or loss. In order for such a grant of patent rights . . . to constitute a sale or exchange, the grant must consist of all substantial rights to the patent.[16]

The Service has also rejected, in general, the application of § 351 to a grant of intellectual property for a limited period, since that would generally not constitute all substantial rights. Revenue Ruling 64-56 indicated that § 351 embraced "[t]he unqualified transfer *in perpetuity* of the exclusive right to use a secret process or other similar secret information qualifying as property . . . or the unqualified transfer *in perpetuity* of the exclusive right to make, use and sell."[17] This was amplified in Rev. Rul. 71-564,[18] where the Service indicated that know-how and patents are "sufficiently akin . . . to warrant the application [to

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"New" Transfers of Intellectual Property, 79 TAXES 211, 219 (2001) (alteration to original for clarification). This interpretation was confirmed by later pronouncements discussed below.

11. *See* Rev. Rul. 64-56, 1964-1 C.B. 133 ("The transfer will also qualify under section 351 of the Code if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding that rights are retained as to some other country's territory."). As discussed *infra* note 203, this last point is consistent with Department of Treasury Regulations. *See* Treas. Reg. § 1.1235-2(b)(1)(i) (as amended in 1980).

12. Rev. Rul. 64-56, 1964-1 C.B. 133 (emphasis added).

13. *See infra* note 23 and accompanying text.

14. Rev. Rul. 64-56, 1964-1 C.B. 133.

15. Rev. Rul. 69-156, 1969-1 C.B. 101.

16. *Id.*

17. Rev. Rul. 64-56, 1964-1 C.B. 133 (emphasis added).

18. Rev. Rul. 71-564, 1971-2 C.B. 179.

know-how], by analogy, of some of the principles of law relating to the transfer of patent rights."[19] The Service went on to state:

> [T]he transferor cannot retain a remainder interest in the patent by giving the transferee the use of the patent for a period less than the remaining statutory length of the patent and be deemed to have transferred all substantial rights in the patent. Likewise, in order for all substantial rights in a trade secret to be transferred, the transferor must transfer to the transferee the use of the trade secret for its full life.[20]

The Service did, however, acknowledge that "perpetuity" for purposes of purported § 351 transfers of know-how or trade secrets could be limited to the time when "it becomes public knowledge and no longer protectible under the applicable law of the country where the transferee is to operate."[21]

In Revenue Procedure 69-19,[22] the Service added the requirement that for know-how or "other secret information" to be treated as property under § 351, the know-how must be "afforded substantial legal protection against unauthorized disclosure and use under the laws of the country from which it is being transferred."[23] While the revenue procedure was issued to address the then conditions or circumstances for advance rulings under § 367, Revenue Procedure 74-36[24] explained that Revenue Procedure 69-19 "is also applicable with regard to advance rulings requested on this matter where the transferee is a domestic corporation."[25]

The Service's position that limited license rights to intellectual property do not fall within § 351(a)'s "property is transferred" requirement was buttressed in Revenue Procedure 83-59.[26] In Revenue Procedure 83-59, the Service required certain representations for issuing favorable § 351 rulings.[27] With respect to patents, the revenue procedure obligated the taxpayer to represent that "[t]he transferor(s) will transfer all substantial rights in such patents or patent applications

19. *Id.*
20. *Id.*
21. *Id.*
22. Rev. Proc. 69-19, 1969-2 C.B. 301.
23. *Id.*
24. Rev. Proc. 74-36, 1974-2 C.B. 491.
25. *Id.*
26. Rev. Proc. 83-59, 1983-2 C.B.575, *modified by* Rev. Proc. 2013-32, 2013-28 I.R.B. 55, *as superseded in part by* Rev. Proc. 2018-1, § 6.03(2).
27. The Service will no longer rule on whether a transaction meets the requirements of § 351 but will rule on "significant" issues under I.R.C. § 351. *See* Rev. Proc. 2018-3, 2018-1 I.R.B. 130, § 3.01(53).

within the meaning of § 1235 of the Code."[28] As to copyrights, the revenue procedure mandated that the taxpayer represent that "[a]ll rights, title and interests for each copyright, in each medium of exploitation, will be transferred to the transferee."[29] With respect to trademarks and trade names (as well as franchises), the revenue procedure required a representation that "[t]he transferor will not retain any significant power, right, or continuing interest, within the meaning of § 1253(b)."[30]

One area worth particular focus is the Service's views pertaining to the field of use restrictions in intellectual property transfers. An example of such a transfer is my alternative fact-pattern,[31] in which A transfers all rights to the patent with respect to delaying the onset of Alzheimer's disease but retains all patent rights to use the drug with respect to its applicability to diminishing the effects of arthritis. J. Clifton Fleming, Jr. observed that Revenue Ruling 64-56 "seemingly departs from the sale or exchange authorities by failing to expressly approve field-of-use restrictions."[32] As noted above, in Revenue Procedure 83-59,[33] the Service indicated that for advance § 351 rulings with respect to copyright transfers a representation is required that "[a]ll rights, title and interests for each copyright, in *each medium of exploitation*, will be transferred to the transferee."[34] My hypothetical § 351 transfers might not pass muster under the Service's public pronouncements, but this is certainly questionable after the decision in *E.I. du Pont de Nemours and Co. v. United States* (*DuPont*),[35] discussed in the next section.

B. E.I. du Pont de Nemours and Co. v. United States *and Other Judicial Authorities*

Although *DuPont* was decided in 1973, it remains an important case for taxpayers making capital contributions of license rights.[36] The case revolves around a grant of "a royalty-free, non-exclusive license to make, use and sell urea herbicides under . . . French patents" to a newly formed French subsidiary, Du Pont de Nemours (France) S.A. (DuPont

28. Rev. Proc. 83-59, 1983-2 C.B. 575, § 4.03.

29. *Id.*

30. *Id.*

31. *Supra* notes 6–7 and accompanying text.

32. J. Clifton Fleming, Jr., *Domestic Section 351 Transfers of Intellectual Property: The Law as It Is vs. the Law as the Commissioner Would Prefer It to Be*, 16 J. CORP. TAX'N 99, 103 (1989). The effect of field and use restrictions upon the sale or exchange requirement in I.R.C. § 1222 is covered below. *See infra* Part III.

33. *Supra* note 29 and accompanying text.

34. Rev. Proc. 83-59, 1983-2 C.B. 575, *modified by* Rev. Proc. 2013-32, 2013-28 I.R.B. 55, *as superseded in part by* Rev. Proc. 2018-1, § 6.03(2) (emphasis added).

35. *See generally* E.I. du Pont de Nemours & Co. v. United States, 471 F. 2d 1211 (Ct. Cl. 1973).

36. *Id.*

France) of E.I. du Pont de Nemours and Company (DuPont).[37] The parties sought the license because "French law provided that French-patented items must be manufactured in France within three years of the issuance of the patent."[38] Pursuant to the license, DuPont France "had the right to sublicense manufacturing for its own needs, but any other sublicensing could only be done with the parent's consent."[39]

Prior to finalizing the license, DuPont requested rulings from the Service regarding whether the transaction complied with the requirements of §§ 351 and 367.[40] The Service determined that the transfer met the then-conditions of § 367,[41] but not those of § 351.[42] The Service's position vis-à-vis § 351 was that the transfer was not a transfer of property because "all substantial rights will not be transferred . . . to the new French company . . . ."[43] Despite the Service's position, DuPont went forward with the grant of the limited license rights to the newly incorporated DuPont France.[44] The Service challenged the purported § 351 transaction as a setoff defense to DuPont's refund claims.[45] If § 351 did not apply, DuPont would have taxable gain to be recognized on the difference between its zero basis in the French patent license rights and their $411,500 value.[46]

The Court of Claims observed that the Service's position for asserting that the transfer did not meet the requirements of § 351 had "vacillated somewhat."[47] The Service's initial position for not ruling favorably was the patent license rights were not property, but the court indicated the Service's position in *DuPont* "now stresses the reasoning of Rev. Rul. 69-156 . . . ."[48] The court quoted Rev. Rul. 69-156 as follows:

> The grant of patent rights to a corporation will constitute a transfer of property within the meaning of section 351 of the Code only if the grant of these rights in a transaction

37. *Id.* at 1212.

38. *Id.*

39. *Id.*

40. *Id.*

41. Under the law then in effect, the court explained that "if the transaction involved transfer of property to a foreign corporation in exchange for its stock, nonrecognition would only be granted if it were established to the Commissioner's satisfaction that the exchange were not part of a plan for the avoidance of federal income tax." *Id.* at 1213. Section 367 has undergone significant changes since then with respect to outbound capital contributions of intellectual property, and these now fall within the taxpayer unfriendly regime of § 367(d).

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* at 1213 n.3.

46. *Id.* at 1213. The court determined their value by the value of the shares in DuPont France received by DuPont in consideration for the capital contribution of the license rights. *Id.*

47. *Id.*

48. *Id.*

> which would ordinarily be taxable, would constitute a sale or exchange of property rather than a license for purposes of determining gain or loss. In order for such a grant of patent rights to . . . constitute a sale or exchange, the grant must consist of all substantial rights to the patent.[49]

In court, the government stressed the § 351 "'exchange' requirement," and equated that factor "with the concept of 'sale or exchange' under the capital gains provisions of the Code."[50] In other words, the Service asserted that since a nonexclusive patent license "would not be eligible for capital gains treatment," it could not constitute a "'transfer' of 'property'" under § 351.[51] The Court of Claims, however, rejected the view that "section 351 embodies the same notions as the capital gains provisions."[52] In reaching its conclusion, the Court of Claims examined "the language of the sections being compared, their individual purposes, their history and context, as well as their treatment by the courts."[53]

The court observed that, as to the language, Congress "did not use identical wording."[54] That is, § 1222(3) requires the "sale or exchange of a capital asset . . ."[55] but "§ 351 speaks of 'property' not of 'capital asset' . . . ."[56] The Court of Claims pointed out that § 351 encompassed transfers of items such as inventory and accounts receivables excluded from capital asset status under § 1221.[57] The court also emphasized that § 351 uses the word "transferred" which is different from § 1222's terminology "sale or exchange."[58] The "difference is obviously not controlling, but the fact that the drafters made the distinction in language cautions against a wholesale and automatic adoption for section 351 of the concepts of the capital gains provisions."[59] The court determined that "[t]he bare words of the statutes do not compel, or even favor, their parallel application."[60]

The Court of Claims seized on "the contrasting purposes of the two parts of the Code as undermining, affirmatively and seriously, the Government's position."[61] The court contrasted the fact that to achieve

49. *Id.* (citing Rev. Rul. 69-156, 1969-1 C.B. 101).
50. *Id.*
51. *Id.*
52. *Id.* at 1213, 1217.
53. *Id.* at 1213.
54. *Id.* at 1214.
55. I.R.C. § 1222(3) (Westlaw through Pub. L. No. 115-281).
56. *DuPont*, 471 F.2d at 1214.
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*

the preferential capital gain treatment, "there must be a complete divestiture of the taxpayer's interest in property of a particular nature,"[62] with § 351's focus on "the transferor . . . [being] required to remain in control, albeit indirectly, after the transfer."[63] The Court of Claims determined that:

> [t]his direct opposition in the aims of the two sets of provisions—the capital gains sections stressing the completeness of disposition by the taxpayer while § 351 is grounded in the taxpayer's continuance in control—supplies a compelling reason for putting aside, in applying the latter, capital gains formulations. Where the goals of two pieces of legislation are contradictory, it is appropriate, if the words permit, to treat them independently and to let the application of each be governed by its own separate purpose.[64]

The Court of Claims buttressed its conclusion by citing precedent from the tax court in *Duncan v. Commissioner*.[65] That case involved a transfer of a judgment claims against the debtor transferee to creditors in return for the receipt of additional shares held by the creditors in the transferee.[66] The issue was whether the transfer came within a predecessor to § 351 (§ 112(b)(5) of the Internal Revenue Code of 1939).[67] An earlier case, *Hale v. Helvering*, held that where debt was settled for cash "there was no 'sale or exchange' since there was no acquisition of property . . . ,"[68] and the court in *Duncan* held § 112(b)(5) to be inapplicable to capital contribution transfers.[69]

The *DuPont* Court of Claims quoted the *Duncan* court as authority for its proposition that "the intent of section 112(b)(5) [of the 1939 Code, now section 351(a)] is to defer the recognition of gain or loss until the continuing interest of the former creditors is finally terminated as, for example, by the disposition of their stock."[70] The Court of Claims indicated that "[i]t was this continuation-of-interest that led to the *Duncan* court's refusal to apply the capital assets 'sale or exchange' test. The relationship had been altered from its original creditor/debtor form, but it had not ended."[71]

62. *Id.*
63. *Id.*
64. *Id.* at 1216.
65. *Id.* (citing Duncan v. Comm'r, 9 T.C. 468 (1947)).
66. *Duncan*, 9 T.C. at 468.
67. *Id.*
68. *DuPont*, 471 F.2d at 1216 (quoting Hale v. Helvering, 85 F.2d 819, 821 (D.C. Cir. 1936) ("Property in the notes as capital assets was extinguished, not sold.").
69. *See Duncan*, 9 T.C. at 471.
70. *DuPont*, 471 F.2d at 1216 (quoting *Duncan*, 9 T.C. at 471).
71. *Id.* (citing Miller & Paine, 42 B.T.A. 586, 593 (1940)).

H.B. Zachary Co. v. Commissioner was another tax court case cited by *DuPont*.[72] One issue in that case was whether a carved-out oil payment by the transferor to its subsidiary constituted "property" for purposes of § 351(a).[73] The tax court rejected the Service's position that this was not property for purposes of § 351.[74] The Service's position was based on *Commissioner v. P.G. Lake, Inc.*[75] and *Fleming v. Commissioner*.[76] In the seminal *P.G. Lake* decision, the legal issue was whether the consideration received by the taxpayer in return for the assignment of oil payment rights, or in one of the five consolidated cases decided, sulfur payment rights, was taxable as ordinary income or capital gain.[77]

The Supreme Court held the payments should be characterized as ordinary income because "[t]he substance of what was received was the present value of income which the recipient would otherwise obtain in the future."[78] *Fleming* involved an exchange of oil payment rights for real estate and whether this transaction came within the nonrecognition rules of the statutory predecessor to § 1031.[79] The court in *H.B. Zachary* stated that "[n]either of these cases involved the nonrecognition of income under section 351, but rather the tax consequences of a sale or exchange of an oil payment under other provisions of the Internal Revenue Code."[80]

According to the Court of Claims in *DuPont*, the Service's best argument for denying § 351 treatment was "that the predecessors of section 351 and the capital-gain-and-loss provisions had their joint birth in the Revenue Act of 1921 where they were placed in very close proximity, and that this juxtaposition continued for many years."[81] The court wrote that:

> [u]ntil 1954, the recognition provision for "sales or exchanges" and the exceptions to the recognition provision (including the forerunners of section 351) were positioned next to each other . . . . The [government] draws the conclusion that, at least where a nonrecognition section uses the word "exchange", Congress intended the very same meaning to be given to that term as in the "sale or exchange" recognition provisions; those nonrecognition sections should simply be read, defendant says, as subordinate

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72. *Id.* at 1216–17 (citing H.B. Zachary Co. v. Comm'r, 49 T.C. 73, 80 (1967)).
73. *H.B. Zachary*, 49 T.C. at 79.
74. *Id.* at 79.
75. *Id.* (citing Comm'r v. P.G. Lake, Inc. 356 U.S. 260 (1958)).
76. *Id.* (citing Fleming v. Comm'r, 241 F.2d. 78 (5th Cir. 1957)).
77. *P.G. Lake*, 356 U.S. at 264.
78. *Id.* at 266.
79. *Fleming*, 241 F.2d at 79 n.2.
80. H.B. Zachary Co. v. Comm'r, 49 T.C. 73, 80 (1967).
81. E.I. du Pont de Nemours & Co. v. United States, 471 F.2d 1211, 1217 (Ct. Cl 1973).

> exceptions to the general provision providing for recognition of gain from a "sale or exchange."[82]

While the Court of Claims acknowledged that "[t]here is obviously some force to this textual contention," this is "overborne by other more powerful factors."[83] The court went on to state that the "cognate origin and statutory juxtaposition are outbalanced by the great variance between the purposes of 351 and of the capital gains sections, and by the clear irrelevance of the concepts from the latter . . . to the goals and theory of the former."[84]

The *DuPont* court also pointed out that the government's argument was somewhat inconsistent in that it "concedes that the license was 'property' in the hands of the transferee, but does not agree that [DuPont] gave up any 'property.'"[85] The Court of Claims also rejected a policy argument asserted by the government that if § 351 addressed carved-out patent rights, "it will be extremely difficult to determine what portion of the transferor's basis for his patent should be carried over to a non-exclusive license, when the licensor retains the right to issue an indeterminate number of additional licenses."[86] The court first noted that "[i]n this particular case there is no problem of basis allocation since [DuPont] claims no basis in the French patents," and other courts have faced "similar problems of proper allocation between retained and transferred value . . . and . . . have been able to reach

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82. *Id.* at 1217–18.

83. *Id.* at 1218.

84. *Id.*

85. *Id.* at 1219. This position was criticized by Suresh T. Advani who wrote:

> The IRS is therefore faced with the difficult argument that the transferee received property, but that the transferor never transferred property. This argument seems especially difficult to make in light of the interplay . . . between Code Sec. 197(f)(7) (which provides that 'any amortizable section 197 intangible shall be treated as property') and the section 197 regulations (which define a section 197 intangible as including a right to use a section 197 intangible).

See Advani, *supra* note 10, at 226. The regulation Advani is referring to is Treas. Reg. § 1.197-2(b)(11). Other commentators, however, observed that while "[t]here is no doubt that the section 197(d) definition of 'section 197 intangibles' is helpful for purposes of section 351 . . . [i]t should be noted that the definition of 'section 197 intangible' in section 197(d) opens with the qualifying words: 'For purposes of this section.'" Katherine M. Bristor, Elizabeth L. McGinley & Anthony Leibler, *Intellectual Property as Transferable Property for Purposes of Section 351*, 21 COMPUTER & INTERNET LAW. 11, 14 (2004). These writers conclude that:

> section 197 does not actually confer section 351 property status upon items contained in the list of "section 197 intangibles"; rather, section 197 simply indicates that these items are capable of being transferred pursuant to section 351 if the requirements therefore, including that transferred items constitute property, are otherwise satisfied.

Id.

86. *DuPont*, 471 F. 2d at 1219.

satisfactory solutions."[87] Furthermore, according to the Court of Claims, while "evaluation of non-exclusive licenses is complicated by the indefiniteness of the number of licenses that may be issued . . . that does not mean that it is impossible to make any appraisal."[88] In doing this valuation, the court opined, "[o]ne may be able, for instance, to weigh the probability, in the specific circumstances, of more licenses being issued."[89] Finally, the court observed that "[i]n similar circumstances, it has been found that difficulty of evaluation should not thwart application of the statute."[90]

The court also dismissed the Service's alternative argument "that applying to this type of transaction can open up the gate to improper tax avoidance by allowing the conversion of ordinary income into capital gain" by pointing out that both the Service and the court employs other methods to prevent these types of abuses.[91] Thus, the court concluded the transfer fit within the ambit of § 351.[92]

The Service's response to *DuPont* has been somewhat inconsistent. While, as Advani points out, "Rev. Rul. 69-156 . . . represent[s] the official position of the IRS, unofficially the IRS appears to give a wink and a nod to taxpayers structuring incomplete transfers."[93] Advani observes that "[r]ulings abound under Code Sec. 355 where, in preparation for a spin-off, the distributing corporation makes an incomplete transfer of

87. *Id.* at 1220.

88. *Id.*

89. *Id.*

90. *Id.* During the Clinton Administration, the *DuPont* holding was proposed as legislation that would have determined the transferee's basis in a license right to the transferee by allocating "the transferor's basis immediately before the transfer . . . among the rights retained by the transferor and the rights transferred on the basis of their respective fair market values" had it been enacted. Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong., 1st Sess. (1999). This proposed legislation would have moved the current I.R.C. § 351(h) to I.R.C. § 351(i) and codified *DuPont's* holding at I.R.C.§ 351(h)(1)(B). *See* Advani, *supra* note 10, at 222; *infra* notes 122–24 and accompanying text for an expanded discussion on the proposed legislation.

91. *DuPont*, 471 F.2d at 1220. Other options the court gave to avoid abuses were "assignment of income, step transactions, and the Commissioner's power to allocate income." *Id.* The court also pointed out that:

> [i]n this instance, we see no such possibility of tax avoidance. Du Pont's subsidiary has a zero basis in the license, under section 362(a), and its gain from use of the patent would be ordinary income, just as it would have been if Du Pont had not formed the subsidiary but had exploited the patent itself. There is no adequate reason here to refuse to apply section 351 according to its terms. Nor have we been shown any real need to adopt a wholesale prophylactic rule, rigidly excluding all transactions of this type from section 351, in order to forestall possible tax avoidance in other circumstances not before us and not even known to exist.

Id.

92. *Id.* at 1221.

93. Advani, *supra* note 10, at 221.

intellectual property to the subsidiary about to be spun off."[94] Advani notes that while the rulings "dutifully cite . . . Rev. Rul. 69-156 and refuse . . . to rule on the tax effects of the incomplete transfer . . . [i]f the IRS had a more fervent belief in the merits of the position, one suspects it would be less inclined to gloss over this aspect of the transaction."[95]

Moreover, a few years after the *DuPont* decision was rendered, General Counsel Memoranda began to signal that some in the Service were prepared to throw in the towel on this issue. General Counsel Memorandum 36,922 stated that, for § 351 post-*DuPont*, they "no longer believe . . . the Service should maintain that all substantial rights in 'know-how' or a patent held by the transferor must be transferred in order to constitute the transfer of property."[96] The following year General Counsel Memorandum 37,178 was issued stating that "it is now the Service's position that the concept 'transfer in exchange' in Code § 351 is not tied to and does not have the same scope as the concept 'sale or exchange' under the capital gains provisions."[97] The General Counsel Memorandum further indicated that "it is no longer the Service's position that Code § 351 requires the transfer [of] all substantial rights in a transaction that would constitute a sale or exchange for purposes of determining gain or loss."[98] Advani observed that "[r]ulings adopting this position were apparently drafted, but never issued."[99]

The Service, however, certainly had second thoughts with the issuance of Revenue Procedure 83-59 discussed above.[100] Moreover, in Private Letter Ruling 9421014, the Service determined that "[t]he transfer by Company of the nonexclusive right to use Trade Name constitutes the transfer of a mere license and not property for purposes of § 351."[101] As a result, the shares in transferee's company were considered taxable.[102]

The Fifth Circuit's holding in *United States v. Stafford*[103] also warrants some discussion. In that case, the taxpayer, DeNean Stafford, was an experienced real estate developer with expertise in hotel

94. *Id.* (citing I.R.S. Priv. Ltr. Rul. 200032014 (May 8, 2000); I.R.S. Priv. Ltr. Rul. 200029037 (July 21, 2000); I.R.S. Priv. Ltr. Rul. 9940013 (Oct. 8, 1999); I.R.S. Priv. Ltr. Rul. 9926036 (July 2, 1999)).

95. Advani, *supra* note 10, at 221.

96. I.R.S. Gen. Couns. Mem. 36,922 (Nov. 16, 1976).

97. I.R.S. Gen. Couns. Mem. 37,178 (June 24, 1977).

98. *Id.*

99. Advani, *supra* note 10, at 220 (citing I.R.S. Gen. Couns. Mem. 38,114 (Sept. 27, 1979)).

100. *See supra* notes 26–34 and accompanying text.

101. I.R.S. Priv. Ltr. Rul. 9421014 (Feb. 23, 1994).

102. *Id.*

103. *See generally* United States v. Stafford, 727 F.2d 1043, 1045 (11th Cir. 1984). Note that this case involved § 721 instead of § 351 and was not a license right with respect to intellectual property. *Id.*

properties.[104] Stafford obtained a legally unenforceable letter of intent from the Life Insurance Company of Georgia (LOG) with respect to the development of a hotel LOG wished to have built on land adjacent to its corporate headquarters.[105] A limited partnership was formed to build the LOG hotel, with Stafford as the sole general partner.[106] Stafford paid cash for two of the twenty units in the partnership and was assigned another one that he and his wife did not report as income in their joint tax return.[107] On audit, the Service assessed a deficiency on the grounds that the value of this unit represented compensation for services.[108] Stafford paid the deficiency but filed a claim for refund asserting the partnership interest given to him was in consideration for a non-taxable contribution of property under § 721.[109]

When the case was appealed again after the remand, it was brought to the newly formed Eleventh Circuit.[110] The court reversed a decision of the district court granting summary judgment to the Service because "the government [had] not met . . . [the] high burden [required for summary judgment]."[111] The Eleventh Circuit observed in a footnote that "[f]or purposes of determining the meaning of the terms 'property' and 'exchange' under § 721(a), noted commentators have made frequent reference to judicial and administrative decisions under § 351."[112] The court continued, stating that "[f]inding the provisions and rationale of §§ 351 and 721 closely analogous, we also will frequently refer to cases decided under § 351 while discussing the issues in the present case."[113] The Eleventh Circuit found that "[a]n enforceable contract would perhaps be assured of property status; but the absence of enforceability does not necessarily preclude a finding that a document, substantially committing the parties to the major terms of a

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104. *Id.* at 1045–46, 1051.
105. *Id.*
106. *Id.* at 1046.
107. *Id.* at 1046–47.
108. *Id.* at 1047.
109. *Id.*
110. *See generally id.* The Eleventh Circuit explained the history of the case:

> [T]he district court granted summary judgment to the Staffords on grounds that the taxpayers' 1969 receipt of the third limited partnership share qualified for nonrecognition treatment under I.R.C. § 721. The former Fifth Circuit reversed . . . and remanded for resolution of an underlying factual dispute.

Id. at 1047. That issue was as follows: "What was the quid pro quo [property or services] for . . . [the receipt by Stafford] of the . . . partnership interest?" Stafford v. United States, 611 F.2d 990, 995 (5th Cir. 1980). On remand, "[t]he district court, after considering cross-motions for summary judgment, granted summary judgment in favor of the government." *Stafford*, 727 F.2d at 1047.

111. *Stafford*, 727 F.2d at 1048.
112. *Id.* at 1049 n.9.
113. *Id.*

development project, is property."[114] Citing a number of cases, including *DuPont*, the court noted that "[a]lthough the Internal Revenue Code does not define property for purposes of § 721 or § 351, the courts have given the term rather broad application."[115] In fact, courts consider the term "to encompass whatever may be transferred."[116] The Eleventh Circuit reasoned that:

> [t]he purpose of §§ 721 and 351 is to permit the taxpayer to change his individual business into partnership or corporate form; the Code is designed to prevent the mere change in form from precipitating taxation. In keeping with this purpose, we can discern no reason to exclude Stafford's transfer of the letter of intent from the protective characterization as "property."[117]

Advani, however, implies that *Stafford* went too far in equating what constitutes "property" for the § 351(a) requirement of "property is transferred" and the § 721(a) requirement of "contribution of property."[118] He points out that "[t]he most significant difference (aside from the fact that one applies to corporations and the other to partnerships) is that Code Sec. 721 has no control requirement."[119] While this is true, it does not negate the court's reasoning that the legislative intent behind both sections was to allow a taxpayer to change the form of ownership of his business without triggering taxation. Accordingly, the word "property" should be interpreted broadly under both provisions.

Advani observes that, despite *DuPont* and the other adverse case law, the Service continues its "refusal to abandon its position in the face of contrary authority."[120] He further notes that "the IRS has not

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114. *Id.* at 1051–52. However, the court did determine that although the letter of intent was

> not enforceable in a strict legal sense, the written documents—i.e., the terms of the July 2 letter, together with the July 3 letter limiting availability of those terms to acceptance within 60 days, and Stafford's August 30 letter of acceptance wherein he agreed to the essential terms of the letter of intent, including the interest on the loan and the lease term—represented an agreement on the major terms that was quite firm in the view of the parties. Both of the principals have testified that they felt bound by the terms of the letter.

Id. at 1053.

115. *Id.* at 1052.

116. *Id.* (quoting Hempt Bros., Inc. v. United States, 354 F. Supp. 1172, 1175 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974)).

117. *Id.* at 1053.

118. *See* Advani, *supra* note 10, at 221.

119. *Id.*

120. *Id.* at 222.

aggressively pursued its position . . . [but] the IRS has continued to maintain it, presumably as a deterrent to abusive transactions."[121]

The Clinton Administration proposed legislation that would have rectified the problem by essentially codifying the holding in *DuPont*, had it been enacted.[122] The bill provided for a new subsection to § 351 that read as follows: "A transfer of an interest in intangible property (as defined in section 936(h)(3)(B)) shall be treated under this section as a transfer of property even if the transfer is of less than all the substantial rights of the transferor in the property."[123] Another subsection, however, added a restriction that "[t]his section shall not apply to a transfer of intangible property developed by the transferor or any related person if such development was pursuant to an arrangement with the transferee."[124] While Professors Bittker and Eustice opine that "[s]ince the proposal is not controversial, its return in a future tax bill is likely,"[125] it has yet to be enacted.

III. DISPOSITIONS OF INTELLECTUAL PROPERTY RIGHTS: TCJA CHANGES & THE MEANINGS OF "PROPERTY" AND "SALE OR EXCHANGE" IN §§ 1221 AND 1222

A. *TCJA Change to § 1221(a)(3)*

In view of the Service's pronouncements that the standards for meeting the requirements for capital gain treatment should apply for determining if a transfer of property meets the requirements of § 351(a), it is useful to examine what are the requirements of the former vis-à-vis intellectual property license rights. Moreover, it is also beneficial to consider the impact of some recent legislative changes to § 1221(a)(3) regarding intellectual property license rights dispositions.

For an individual to obtain preferential capital gain treatment, "there must be: (1) a sale or exchange, (2) of a capital asset, (3) that was held for more than one year."[126] Public Law 115-97, informally known as the Tax Cuts and Jobs Act (TCJA),[127] creates an additional roadblock

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121. *Id.* Advani indicates that the Service's "primary concern is that taxpayers may use Code Secs. 351 and 721 to convert capital gain into ordinary income." *Id.* at 230 n.147.

122. H.R. 2488 § 1513, 106th Cong., 1st Sess. (1999).

123. *Id.*

124. *Id.*

125. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.03 n.60 (Thomson Reuters Tax & Accounting ed., 2018).

126. Philip G. Cohen, *The Long (v. Commissioner) and Short of the Substitute for Ordinary Income Doctrine*, 13 PITT. TAX REV. 151, 154 (2016) (citing §§ 1222(3), (11), 1(h)(1)). There are currently no preferential tax rates for C corporations with long-term capital gains. *Id.*

127. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 12002, 131 Stat. 2054, 2095 (2017). The official name of the legislation is: "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." *Id.* at 2054.

to preferential capital gain treatment by expanding an exclusion from capital asset status for taxpayers disposing of intellectual property.[128] Section 1221(a)(3), which provides an exclusion from capital asset status, was amended by TCJA to read as follows:

> (3) *a patent, invention, model or design (whether or not patented), a secret formula or process*, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—
>
> (A) a taxpayer whose personal efforts created such property,
>
> (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
>
> (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).[129]

Thus, effective for dispositions after December 31, 2017, capital asset classification is now denied, among others, to (1) "a taxpayer whose personal efforts created . . . a patent, invention, model or design (whether or not patented), a secret formula or process" or (2) "a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer" from "whose personal efforts created such property."[130]

TCJA makes a corresponding change to § 1231. Section 1231(b)(1)(C), as amended by TCJA, excludes from the category "property used in the trade or business . . . *a patent, invention, model or design (whether or not patented), a secret formula or process*, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of § 1221(a) . . . ."[131]

128. *Id.* at 2133. The law is designated H.R. 1 for U.S. congressional purposes. *Id.*

129. I.R.C. § 1221(a)(3) (Westlaw through Pub. L. No. 115-281). Emphasis inserted to reflect that § 13314(a) of the TCJA added "a patent, invention, model or design (whether or not patented), a secret formula or process," before "a copyright" in paragraph (a)(3). The change is effective for dispositions occurring after December 31, 2017. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. at 2054, 2133 (2017).

130. I.R.C. § 1221(a)(3) (Westlaw through Pub. L. No. 115-281).

131. *Id.* Emphasis inserted to reflect that § 13314(b) of the TCJA added "a patent, invention, model or design (whether or not patented), a secret formula or process," before "a copyright" in § 1231(b)(1)(C). Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. at 2054, 2133 (2017).

There is some confusion as to the effect of TCJA changes made to § 1221(a)(3) with respect to § 1235. On its face, § 1235 remained unaltered by TCJA. Kyle Richard points out that:

> [b]efore the TCJA, sections 1221 and 1235 were in alignment: Self-created patents were treated as capital assets under section 1221 and were also subject to a special rule that treated gain from an inventor's transfer of "all substantial rights" to a self-created patent as a long-term capital gain transaction.[132]

Section 1235 reads, both prior to and after TCJA, that "[a] transfer (other than by gift, inheritance or device) of property" by an inventor or other "holder":

> consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights . . . shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of such transfer are:
>
> (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or
>
> (2) contingent on the productivity, use, or disposition of the property transferred.[133]

Section 1235(b), in turn, defines holder to mean in addition to "any individual whose efforts created such property,"[134] "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent"[135] provided that "such individual is neither: (A) the employer of such creator, nor (B) related to such creator."[136] The word "related" is in turn defined for this purpose as "persons specified within any one of the paragraphs of section 267(b) or persons described in section 707(b)" with certain modifications listed in the accompanying footnote.[137]

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132. Kyle Richard, *Does the Tax Cuts and Jobs Act Affect University Tech Transfer?*, TAX NOTES (June 25, 2018), https://www.taxnotes.com/tax-notes/unrelated-trade-or-business/does-tax-cuts-and-jobs-act-affect-university-tech-transfer/2018/06/25/283tz.

133. I.R.C. § 1235(a) (Westlaw). (Westlaw through Pub. L. No. 115-281). The Treasury Regulations provide helpfully to taxpayers that "[i]t is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met." Treas. Reg. § 1.1235-2(a) (as amended 1980).

134. *Id.* § 1235(b)(1).

135. *Id.* § 1235(b)(2).

136. *Id.*

137. *Id.* § 1235(c). Section 1235(c) goes on to provide:

> except that, in applying section 267(b) and (c) and section 707(b) for purposes of this section:

Kyle Richard points out that the "lack of changes [in TCJA] was not an oversight on the part of Congress. . . ."[138] He notes that the initial House bill had provided for the complete repeal of § 1235.[139] While he observes that commentators have conflicting views squaring the changes to § 1221(a)(3) by TCJA with leaving § 1235 intact,[140] he concludes that "[t]here is room to reconcile the changes to section 1221 with the decision not to change section 1235 in a manner that gives meaning to both provisions."[141] He writes that:

> [t]he changes to section 1221 and related congressional intent indicate that, in general, Congress intends for transfers of patents to be subject to taxation at the ordinary income rates. However, the remaining narrow exception to ordinary income treatment provided by section 1235 is not abrogated by this change to section 1221. Although this indicates that the tax consequences for transactions qualifying under section 1235 would remain unchanged, the TCJA raises the stakes in ensuring that transactions do, in fact, qualify under section 1235 . . . .[142]

Section 1235 was enacted, in part, to encourage professional individual inventors, who before it became law, had been ineligible for capital gains treatment because of the "stock in trade" capital asset exclusion now provided in § 1221(a)(1).[143] The legislative history to § 1235 specifically indicates that the pre-I.R.C. § 1235 distinction "between amateur and professional inventors . . . tends to discourage scientific work."[144] Whether or not excluding those transfers otherwise falling within § 1235 from the TCJA changes discussed above is sound policy is certainly open to debate.[145] In the absence of a technical

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> (1) the phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in section 267(b) or 707(b), and
>
> (2) paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

Id.

138. *See* Richard, *supra* note 132.
139. *Id.* (citing H.R. 1 § 3312).
140. *Id.*
141. *Id.*
142. *Id.*
143. S. Rep. No. 1622, at 113–14 (1954).
144. *Id.* at 113.
145. Professor Anthony P. Polito weighed in on what Congress may have intended and what should be done vis-à-vis § 1235 in an interesting recent article in Tax Notes. Anthony P. Polito, *Did Congress Goof? Legislating Taxation of Self-Created Patents*, 161 TAX NOTES 51 (2018). Professor Polito argues that Congress may have intended to preserve § 1235 treatment for investors. *Id.* at 63. If so, he writes:

correction or other statutory change, § 1235 provides a path to capital gain treatment that would be otherwise closed by the TCJA statutory changes.

B. The Terms "Property" in § 1221(a) and "Sale or Exchange" in § 1222

Section 1221 provides in pertinent part that "[f]or purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include . . . [eight categories of assets]."[146] Section 1222(3) defines "long-term capital gain" as "gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income."[147] Thus, absent special statutory rules, such as §§ 1235 and 1231, capital gain characterization requires the asset transferred be "property" under § 1221(a), that is not specifically excluded under the eight categories therein, and that transfer is a "sale or exchange" under § 1222.[148] As noted above, for an

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> The cleanest solution, the one most likely to produce the desired result is further legislation: an amendment to section 1235(b). It would need to be amended so that it does not apply to the creator of a patent but continues to apply to investors for money or money's worth in an individual's invention. The amendment language of section 1235 would read as follows:
>
> (b) "Holder" defined — For purposes of this section, the term "holder" means individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to any individual whose efforts created such property prior to actual reduction to practice of the invention covered by the patent, if such individual is neither:
>
> (1) the employer of such creator, nor
>
> (2) related to such creator (within the meaning of subsection (c)).

Id. at 63–64.

146. I.R.C. § 1221(a) (Westlaw through Pub. L. No. 115-281).

147. *Id.* § 1222(3).

148. *Id.* §§ 1221, 1222. Section 1231 could apply in the case of a transfer of business intellectual property that was amortizable and thus denied capital asset status by virtue of § 1221(a)(2) but that fell outside the scope of § 1221(a)(3) discussed above. *See supra* note 146. While this article addresses to some extent the impact to capital gain characterization of transfers of intellectual property by virtue of §§ 1235 and 1253, there are other specific statutory provisions that could apply but are beyond the scope of this article. For example, § 1249(a) provides

> [g]ain from the sale or exchange of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right to any foreign corporation by any United States person (as defined in § 7701(a)(30)) which controls such foreign corporation shall, if such gain would (but for the provisions of this subsection) be gain from the sale or exchange of a capital asset or of property described in § 1231, be considered as ordinary income.

See id. § 1249(a). Another statutory rule having potential applicability is contained in § 1234A. *See id.* § 1234A.

individual to benefit for the preferential tax treatment for "net capital gain" the capital asset additionally must have been held for more than one year.[149]

An initial hurdle for a taxpayer seeking capital gain treatment with respect to a transfer of an intellectual property license is to make sure that the asset in question does not fall within one of the eight categories of asset exceptions to capital asset treatment with a particular focus on § 1221(a)(3). Absent a technical correction or other statutory change, however, § 1235 still provides a path to capital gain treatment even if the property falls under § 1221(a)(3), or any of the other statutory exceptions to capital asset status.[150] The next step is to determine if what is transferred is "property" a requirement for both capital asset status under § 1221 and the special treatment accorded by § 1235(a).

As to what constitutes property for purposes of § 1221, the author pointed out in an earlier article that the Supreme Court construed the word property in the statute narrowly.[151] The earlier article quoted Professor Stanley S. Surrey on why this is necessary:

> [I]n one sense everything that the taxpayer holds is "property" and hence will be a capital asset, at this point it would seem to follow that all income could well be "capital gain" . . . unless a particular item of property is covered by an exclusion . . . the courts have in some cases attempted to produce a more reasonable situation by refusing to consider the term "property" as being here used by Congress in the normal, all-inclusive sense in which it is used elsewhere in the Code.[152]

Miller v. Commissioner illustrates the narrow definition of the word property used by the courts.[153] In that case the widow of the famous band leader, Glenn Miller, claimed capital gain treatment for payment to her in connection with a film about her late husband.[154] The Second Circuit held that the widow did not make a payment for property, reasoning that:

> the "thing" bought, or more appropriately "bought off," seems to have been the chance that a new theory of

149. I.R.C. § 1222(3) (Westlaw).

150. *See* Richard, *supra* note 132.

151. *See, e.g.*, Corn Prod. Ref. Co. v. Comm'r, 350 U.S 46, 52 (1955) (stating that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose."); *see* Cohen, *supra* note 126, at 154.

152. *See* Cohen, *supra* note 126, at 155 (quoting Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 988 (1956)).

153. Miller v. Comm'r, 299 F.2d 706, 710–11 (2d Cir.), *cert. denied*, 370 U.S. 923 (1962). The author has also examined this case elsewhere. *See* Cohen, *supra* note 126, at 155.

154. *Miller*, 299 F.2d at 707.

> "property" might be advanced, and that a lawsuit predicated on it might be successful. It was a purchase . . . for freedom from the danger that at a future date a defensible right constituting "property" would be found to exist. But it didn't pay for "property."[155]

A substitute for ordinary income also does not constitute property for purposes of § 1221.[156] The Supreme Court in the renowned decision, *Commissioner v. P.G. Lake, Inc.*, denied capital gain treatment where, "[t]he substance of what was received was the present value of income which the recipient would otherwise obtain in the future."[157] The Court found that "consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property."[158] Another important Supreme Court case about a substitute for ordinary income is *Commissioner v. Gillette Motor Transport, Inc.*[159] In that decision, the taxpayer received compensation "for the temporary taking by the government of its business facilities during World War II."[160] The Supreme Court held the compensation from the seizure to be ordinary income and not capital gain.[161] While the Court acknowledged that the taxpayer was deprived of property, it declared that "not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset."[162] The Court stated that "the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent."[163]

Despite the foregoing, in general, a license right to intellectual property constitutes property for § 1221 purposes. An important case in this regard is the Second Circuit decision of *Commissioner v. Ferrer*.[164] The court considered whether a taxpayer, actor Jose Ferrer, was entitled to capital gain treatment for certain payments he received in connection with the motion picture *Moulin Rouge* about the artist Henri de Toulouse Lautrec.[165] Ferrer acquired these rights from Pierre LaMure, the author

155. *Id.* at 710.

156. *See, e.g.*, Cohen, *supra* note 126, at 156.

157. Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 266 (1958).

158. *Id.*

159. Comm'r v. Gillette Motor Transp., Inc., 364 U.S. 130, 130 (1960). The author also considers this case in a prior article. *See* Cohen, *supra* note 126, at 165.

160. *Gillette Motor Transp.*, 364 U.S. at 130.

161. *Id.* at 136.

162. *Id.* at 134.

163. *Id.* at 135.

164. Comm'r v. Ferrer, 304 F.2d 125, 126 (2d Cir. 1962); *see* Cohen, *supra* note 126, at 167–72, for an extensive discussion of the case.

165. *Ferrer*, 304 F.2d at 126.

of the novel *Moulin Rouge* and the play *Monsieur Toulouse*, which was based on the novel.[166]

Ferrer gained three rights from LaMure's novel and play, which were the focus of the tax litigation: (1) "'the sole and exclusive right' to produce and present . . ." the play in the United States and Canada with some production privileges elsewhere,[167] (2) the "power . . . to prevent any disposition of the motion picture rights until June 1, 1952" or longer, if certain requirements were met, and the power "to prevent disposition of radio and television rights"[168] and (3) the claim to "40% share of the proceeds of the motion picture and other rights if he produced the play."[169]

After director John Huston contacted Ferrer about playing Toulouse-Lautrec in a film he was planning, Ferrer and LaMure reached an agreement with Huston's production company, Moulin Rouge Productions, Inc.[170] Furthermore, Ferrer and LaMure also entered into a letter agreement.[171] One of the results of the foregoing was that in 1953, Ferrer received about $179,000 for the relinquishment of contractual rights he had with LaMure.[172]

As to the consideration he received for the first right, which is the payment the court characterized as "lease of the play,"[173] the Second Circuit held that Ferrer was entitled to capital gain treatment[174] and that he "had an 'equitable interest' in the copyright of the play."[175] The court also indicated that it saw "no basis for holding that amounts paid [to] Ferrer for surrender of his lease of the play . . . would have been ordinary income."[176] That "payment to Ferrer might be spread over a number of years rather than coming in a lump sum" was irrelevant in the court's analysis for determining capital gain characterization.[177]

While irrelevant to the question of whether a license right to intellectual property is property for capital asset status purposes, the Second Circuit determined that the second right, i.e., Ferrer's "negative power . . . to prevent any disposition of the motion picture, radio and television rights until after production of the play" was also property for

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166. *Id.*
167. *Id.* at 127.
168. *Id.* at 131.
169. *Id.*
170. *Id.* at 128.
171. *Id.*
172. *See id.* at 128–29.
173. *Id.* at 131.
174. *Id.* at 132–33.
175. *Id.* at 132.
176. *Id.*
177. *Id.* at 133.

capital asset purposes.[178] Ferrer thus properly treated the payment as capital gain.[179] However, the payment for the third right, namely Ferrer's "right to receive 40% of the proceeds of the motion picture and other rights if he produced [*Monsieur Toulouse*]" was not capital gain.[180] The court determined payment for the third right was ordinary income because "Ferrer was to 'have no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive the Manager's share of the proceeds.'"[181] In other words, the Second Circuit found that the third right was not a capital asset because Ferrer lacked "an affirmative equitable interest in the motion picture or other rights, as distinguished from his temporary negative 'encumbrance' on them."[182] Finally, the court concluded that the sale or exchange condition was satisfied, noting that there should be no distinction between a sale to a third person and a release to a grantor.[183] The Second Circuit found that the release of Ferrer's rights to LaMure with a third party payor was effectively the same as a sale to the third party who could then release them.[184] The court reasoned that tax law is concerned with the transfer itself, rather than the recipient of the transfer.[185]

While there is authority that intellectual property license rights can constitute a capital asset (e.g., *Ferrer*), there are exceptions depending upon the particular fact pattern. Obtaining capital asset status can, however, prove academic in the absence of a sale or exchange. Moreover, the grant of a legal license right to intellectual

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178. *Id.*

179. *See id.*

180. *Id.*

181. *Id.* at 134.

182. *Id.*

183. *Id.* at 131.

184. *Id.*

185. *Id.* Congress enacted I.R.C. § 1234A after *Ferrer*, which now provides that:

> [g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of:
>
> (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
>
> (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation agreement).

I.R.C. § 1234A (Westlaw through P.L. 115–281). The pre-I.R.C. § 1234A litigation as to whether relinquishment of a property right satisfied the "sale or exchange" requirement was somewhat inconsistent. *See, e.g.*, Howard J. Rothman et al., *Capital Assets – Related Issues*, Portfolio 562-1 (BNA) § I.B.2.d.

property that does not convey all substantial rights to the recipient is generally not treated as a sale or exchange.

In *Bell Intercontinental Corp. v. United States*, the taxpayer, an aircraft manufacturer, received certain payments for the transfer of patents and other rights.[186] The court considered whether the transfers constituted sales, which would warrant capital gain treatment, or licenses, which would be taxed as ordinary income.[187] The Court of Claims, in reaching different conclusions for the various agreements in question, set forth the distinction between a sale and a license as follows:

> By way of background, a patent confers upon the owner the right to exclude others from making, using or selling the invention during the life of the patent, and in order that a transfer constitute a sale, there must be a grant of all substantial rights of value in the patent. The transfer of anything less is a license which conveys no proprietary interest to the licensee . . . . Whether a transfer constitutes a sale or license is determined by the substance of the transaction and 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.[188]

The Court of Claims also observed that the distinction between sale and license "does not depend upon the labels or the terminology used in the agreement; hence, the fact that an agreement is termed a license and that the parties are referred to as licensor and licensee is not decisive."[189] The court also explained that whether a patent transfer is deemed a sale or license is not "governed by the method of payment, and it is, therefore, immaterial that payment is based on a percentage of sales or profits, or on an amount per unit manufactured."[190]

The distinction between whether a transfer is a sale or license does not apply to the transfer of franchises, trademarks, or trade names because § 1253(c) specifically provides that:

> [a]mounts received or accrued on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be treated as amounts received or accrued

186. Bell Intercont'l Corp. v. United States, 381 F.2d 1004, 1010 (Ct. Cl. 1967).
187. *Id.* at 1009.
188. *Id.* at 1010–11.
189. *Id.* at 1011.
190. *Id.*

> from the sale or other disposition of property which is not a capital asset.[191]

Thus, the assignment of trademark X, in which the transferor receives contingent consideration of, for example, 5% of net sales of products bearing trademark X, would be denied capital gain treatment under the statute.

The Court of Claims in *Bell Intercontinental* also indicated that "clauses in an agreement permitting termination by the grantor upon the occurrence of stated events or conditions will not preclude the transaction from being considered a sale."[192] The theory is that such clauses are considered to be conditions subsequent.[193] In contrast, ordinary income characterization is appropriate for "a transfer limited in duration to a period less than the remaining life of the patent, or a transfer . . . terminable by the grantor not on the happening of a future event beyond his control but at his own discretion prior to the patent's expiration date . . . ."[194] So, if A transfers an interest in a patent for less than its legal life to a third party for cash consideration, it would be characterized as a license for tax purposes. In other words, it would not be a sale or exchange and payments received would be treated as ordinary income.

The requirement to transfer all substantial rights, or as characterized by some authorities, simply "substantial rights,"[195] to obtain sale or exchange is not limited to patents. For example, in *Pickren v. United States*, the taxpayers entered into an agreement to transfer secret formulas and trade names relating to liquid wax products for a period of twenty-five years, subject to early termination "by the event of an unremedied default by" the assignee.[196] The Fifth Circuit held "that such [an] agreement did not effect a transfer of all the substantial rights [in the transferred assets] . . . and that the payments made thereunder . . . were ordinary income."[197] Pertinent to the court's determination was that "the secret formulas had a useful life that would extend more than 25 years," from the date of the agreement, resulting in the taxpayer retaining substantial rights in the transferred property.[198]

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191. I.R.C. § 1253(c) (Westlaw through P.L. 115-281).

192. *Bell Intercont'l*, 381 F.2d at 1011.

193. *Id.*

194. *Id.* at 1020–21.

195. *See* PHILIP F. POSTELWAITE, DAVID L. CAMERON & THOMAS KITTLE-KAMP, FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES & INTANGIBLE ASSETS ¶ 1.05[2][a] (2018) (discussing the distinction).

196. Pickren v. United States, 378 F.2d 595, 600 (5th Cir. 1967).

197. *Id.* at 601.

198. *Id.* at 600.

Notably, *Pickren* was a pre-I.R.C. § 1253 decision. Today, determining whether income on a trade name (trademark or franchise) transfer is capital gain or ordinary income would be governed by that section.[199] Section 1253(a) mandates ordinary income treatment if the transferor retains a "significant power right, or continuing interest" in the transferred trade name, trademark, or franchise.[200] Section 1253(c) compels ordinary income treatment on contingent payments received by the transferor because of the assignment of these assets.[201]

As noted above, § 1235(a) requires that the "transfer . . . of property [must] consist . . . of all substantial rights to a patent, or an undivided interest therein" to be a sale or exchange of a patent.[202] The Treasury Regulations under § 1235 define the term "all substantial rights" to encompass:

> all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term all substantial rights to a patent does not include a grant of rights to a patent: (i) Which is limited geographically within the country of issuance; (ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent; (iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or (iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.[203]

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199. I.R.C. § 1253 (Westlaw through Pub. L. No. 115-281).

200. *Id.* § 1253(a)–(b).

201. *Id.* § 1253(c).

202. *Id.* § 1235(a).

203. Treas. Reg. § 1.1235-2(b)(1) (as amended 1980). Under the Treasury Regulations, a person is considered the owner of an undivided interest in all substantial rights to a patent for purposes of § 1235(a) when he owns the same fractional share of each and every substantial right to the patent. *Id.* § 1.1235-2(c). It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. *Id.* A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent. *Id.* The Treasury Regulations also indicates that the following rights are not substantial for purposes of § 1235 and can be retained by the holder where:

> (i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving

The above-mentioned Treasury Regulations permit geographic divisions of patents, but only where the divisions are between different countries.[204] For example, transferring a Canadian patent while keeping a U.S. patent could constitute the transfer of "all substantial rights to a patent,"[205] but the granting of patent rights for use in Texas while retaining the rights elsewhere in the United States would not be. While some older cases have held the intra-country geographic restrictions in § 1235 regulations invalid,[206] more recent authority has sustained the Treasury Regulation's position.[207] Inter-country geographic divisions

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> transfer of an exclusive license to manufacture, use, and sell for the life of the patent;
>
> (ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

Id. § 1.1235-2(b)(2).

The Treasury Regulations also provides:

> [e]xamples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred . . . :
>
> (i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;
>
> (ii) The failure to convey to the transferee the right to use or to sell the patent property.

Id. § 1.1235-2(b)(3).

204. Kueneman v. Comm'r, 628 F.2d 1196, 1198 (9th Cir. 1980) (quoting Treas. Reg. § 1.1235-2).

205. Treas. Reg. § 1.1235-2(b)(1) (as amended 1980).

206. *See* Rodgers v. Comm'r, 51 T.C. 927, 931 (1969), *acq. in result*, 1973-2 C.B. 3; *see also* Estate of Klein v. Comm'r, 61 T.C. 332, 332 (1973), *rev'd*, 507 F.2d 617 (7th Cir. 1974). There are also pre-I.R.C. § 1235 cases that permit capital gain treatment when the transfer is limited to the right for a part of a country. For example, in *Marco v. Comm'r*, 25 T.C. 544, 550 (1955), *acq.*, 1958-2 C.B. 3, a pre-I.R.C. § 1235 decision, the tax court accorded capital gain treatment for patent rights transferred for a portion of the United States.

207. *See, e.g.*, *Kueneman*, 628 F.2d at 1200 stating:

> [I]t is clear that appellants' geographically limited transfer does not entitle them to capital gains treatment under § 1235. A patent gives the patent holder the monopoly right to make, use, and sell the patented invention throughout the United States during the life of the patent . . . and to exclude others from doing so. To qualify for the capital gains advantage it is this right that must be transferred, and in the context of a geographical transfer it must include all areas of the United States in which the patented invention has potential value. Appellants relinquished their monopoly rights in the patented rock-crushing machine only in the eastern portion of the United States. They transferred less than all the monopoly rights represented by the patent, retaining the exclusive rights to make, use, and vend the patented machine in the western portion of the United States.

The court did, however, add that "[t]he record does not indicate that these retained monopoly rights were not substantial." *Id.*

generally should be valid for patent transfers outside of § 1235, as well as any other intellectual property conveyances.[208]

While field of use fragmentation prevents § 1235 from applying because, under the Treasury Regulations, "all substantial rights to the patent" have not been transferred,[209] there is some helpful authority that a patent transfer not subject to § 1235 may very well not prevent sale or exchange treatment.

In *Merck & Co. v. Smith*, a pre-I.R.C. § 1235 case, the Third Circuit found that the taxpayer was entitled to capital gain treatment because a sale had transpired for tax purposes.[210] In that case, there was an assignment by a predecessor company to Merck "granting to [American Cyanide Company] the exclusive right to make, use and sell 2-sulfonamido pyrimidine, [i.e.,] sulfadiazine, and the 'organic and inorganic salts thereof.' Sulfadiazine was one of the claims in the generic patent for sulfonamido pyrimidines issued by the patent office."[211] The court rejected the government's assertion that it was not a sale because "it could not carve out from the patent issued to it for sulfonamido pyrimidines (the generic patent) the 2-sulfonamido pyrimidine which it purported to pass over to Cyanamid . . . ."[212] The Third Circuit indicated that "[o]ne who owns a single invention patent may 'sell' its use in a particular territory or industry."[213] The court also noted that field of use fragmentation does not negate sale or exchange treatment with respect to copyrights and trademarks.[214]

One of the cases cited in *Merck* for the notion that field of use patent fragmentation does not prevent sale or exchange treatment (outside of § 1235) is *United States v. Carruthers*.[215] The question there was whether a patent transfer qualified for capital gain treatment where the

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208. In its ruling, the Service held that § 1253 would not result in ordinary income treatment where a taxpayer transferred certain foreign trademarks but retained its U.S. trademark counterparts, so long as "no significant power, right or continuing interest" in the foreign trademarks was retained. *See* I.R.S. Priv. Ltr. Rul. 9852033 (Sept. 29, 1998).

209. Treas. Reg. § 1.1235-2(b)(1) (as amended 1980). The regulations have been held valid with respect to denying field of use fragmentation. *See, e.g.*, Blake v. Comm'r, 615 F.2d 731, 735 (6th Cir.), *cert denied*, 449 U.S. 832 (1980); Mros v. Comm'r, 493 F.2d 813, 817 (9th Cir. 1974); Fawick v. Comm'r, 436 F.2d 655, 656 (6th Cir. 1971). In an early § 1235 decision, *Rouverol v. Comm'r*, 42 T.C. 186, 194 (1964), *nonacq.*, the tax court held that capital gain treatment was permitted under I.R.C. § 1235 despite the fact that there was a separation of the patent into different fields of application. This decision appears, however, highly questionable in light of the more recent decisions upholding the Treasury Regulations prohibition of the field of use fragmentation under I.R.C. § 1235. *E.g.*, *Mros*, 493 F.2d at 817.

210. Merck & Co. v. Smith, 261 F.2d 162, 165 (3d. Cir. 1958).

211. *Id.* at 163.

212. *Id.* at 165.

213. *Id.*

214. *Id.*

215. United States v. Carruthers, 219 F.2d 21, 21 (9th Cir. 1955).

conveyance was limited to its use in the tuna industry.[216] Both the taxpayer and the government cited a notable non-tax Supreme Court patent decision, *Waterman v. Mackenzie*.[217] The Ninth Circuit in *Carruthers* sets forth the *Waterman* test as follows:

> The monopoly thus granted is one entire thing, and cannot be divided into parts, except as authorized by those laws. The patentee or his assigns may, by instrument in writing, assign, grant, and convey, either (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. 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.[218]

The Ninth Circuit in *Carruthers* indicated that the Government provided "[n]o explanation . . . nor has it proffered any policy argument as to why a transfer enveloping an industry should be given such different tax treatment from a transfer encompassing an area."[219] Furthermore, the court held that "if the Waterman test [were] applied . . . the taxpayers would pass the test."[220] The case's precedential value, however, is somewhat limited because, among other things, "the patents had no established value for any purpose other than processing tuna fish . . . ."[221]

Another case, cited in *Merck* with respect to patent field of use fragmentation, is *First National Bank of Princeton v. United States*.[222] In that case, one of the grounds asserted by the government for denying capital gain treatment was the transferor's "reservation of rights to use his invention on [things] other than toothbrushes[, for which it was intended]."[223] The court held that "even with the reservation of rights for use in other industries, the grant . . . may still qualify as a sale for tax

216. *Id.* at 22–23.
217. *Id.* at 24 (citing Waterman v. MacKenzie, 138 U.S. 252, 255 (1891)).
218. *Id.* (quoting *Waterman*, 138 U.S. at 255).
219. *Id.*
220. *Id.* at 25.
221. *Id.*
222. First Nat'l Bank of Princeton v. United States, 136 F. Supp. 818 (D.N.J. 1955).
223. *Id.* at 821.

purposes."[224] As with *Carruthers*, however, the patent's "monetary value [outside of its use with toothbrushes] was highly speculative."[225]

The impact of field of use restrictions on sale or exchange treatment for patents outside of the scope of § 1235 remains gray. Harsha Reddy has cautioned that the Service may very well contest capital gain characterization in such circumstances.[226] She also pointed out the lack of authority for field of use retention with respect to sale or exchange treatment for know-how transfers.[227]

An important field of use restriction case in the trademark area is *Conde Nast Publications, Inc. v. United States*.[228] In that case, the taxpayer conducted its principal business, the publication of ladies' fashion magazines, under the "Vogue" trademark and trade name.[229] It also had a dress patterns business under the same trademark and trade name, which it sold to Butterick Company, Inc. (Butterick) in 1961.[230] It was critical to Butterick to obtain "the right . . . to use the 'Vogue' name in the pattern business."[231] The arrangement created a licensing agreement where Butterick had "the sole and exclusive right and license to use the trademark 'Vogue' in the United States, Canada, England and Australia as well as anywhere else in the world where it could lawfully do so in connection with its paper dress pattern business." [232] In exchange for the dress pattern business and use of the Vogue name, the taxpayer received a lump sum plus yearly payments of 1% on all sales of dress patterns by Butterick.[233] The issue before the court was whether the taxpayer was correct in treating the annual payments it received in 1967 and 1968 as capital gain.[234] In determining whether the taxpayer was entitled to capital gains treatment, the court stated "the taxpayer did transfer a complete bundle of rights in a distinct and separable portion of the trademark and name."[235] The Second Circuit observed that the "trademark and name had acquired secondary meanings in two distinct and separable businesses, and the taxpayer transferred the rights to the use of the trademark and name in one of the businesses at

224. *Id.* at 824.
225. *Id.*
226. Reddy, *supra* note 1, at § II.A.2.(a)(2) n.424.
227. *Id.* § II.B.6.
228. Conde Nast Publ'ns, Inc. v. United States, 575 F.2d 400, 400 (2d Cir. 1978) (The case, however, involved tax years prior to I.R.C. § 1253 becoming effective.).
229. *Id.* at 402.
230. *Id.*
231. *Id.*
232. *Id.*
233. *Id.* at 403.
234. *Id.* at 404.
235. *Id.* at 405.

the same time that it sold that business as a going concern."[236] Thus, capital gain treatment was permitted where a trademark was fragmented by fields of use.

The Second Circuit in *Conde Nast* commented that in a prior decision of that court, *Cory v. Commissioner*,[237] a determination was made that a sale for capital gains purposes could transpire where a copyright to the printed form of a book was transferred but the motion picture or other dramatic production rights were retained.[238] The court in *Cory*, however, denied capital gain treatment because "the amount of payments to the transferor remained indeterminate."[239]

Herwig v. United States involved a copyright transfer.[240] The case is also cited in *Merck*.[241] In *Herwig*, the court held that a sale, and not a license, transpired when the taxpayer transferred the exclusive motion picture rights to her book.[242] The court noted that it was logical, practical, and just "to consider the exclusive and perpetual grant of any one of the 'bundle of rights' which go to make up a copyright as a 'sale' of personal property rather than a mere 'license.'"[243] The reasoning of the case was followed by the Service in Revenue Ruling 54-409.[244] Furthermore, the Service held in Revenue Ruling 60-226 that "the consideration received by a proprietor of a copyright for a grant transferring the exclusive right to exploit the copyrighted work in a *medium* of publication throughout the life of the copyright shall be treated as proceeds from a sale of property."[245] Thus, at least with respect to some forms of intellectual property, not only the courts but also the Service has recognized that the retention as to certain fields of use does not prevent sale or exchange treatment to the rights assigned for a different medium of use.

C. Dispositions of Intellectual Property Rights: Variations of the

236. *Id.*

237. 230 F.2d 941, 942 (2d Cir.), *cert. denied*, 352 U.S. 828 (1956).

238. *Conde Nast*, 575 F.2d at 404 (citing *Cory*, 230 F.2d at 944).

239. *Cory*, 230 F.2d at 944.

240. Herwig v. United States, 105 F. Supp. 384, 384 (Ct. Cl. 1952).

241. Merck & Co. v. Smith, 261 F.2d 162, 165 (3d Cir. 1958).

242. *See Herwig*, 105 F. Supp. at 392.

243. *Id.* at 389.

244. Rev. Rul. 54-409, 1954-2 C.B. 174, *modified by* Rev. Rul. Rev. Rul. 60-226, 1960-1 CB 26 (preserving Rev. Rul. 54-409 with respect to recognizing field of use fragmentation did not bar sale and exchange treatment).

245. Rev. Rul. 60-226, 1960-1 CB 26 (emphasis added). This position was initially espoused by the Service in Rev. Rul. 54-409, 1954-2 C.B 174.

Introductory Hypothetical

Let us return to the introductory hypothetical. Suppose that instead of transferring the patent to the corporate joint venture, A assigns the rights to the patent, for cash, to an unrelated party for less than its legal life. This would result in a license for tax purposes, and therefore ordinary income characterization, because of the lack of a sale or exchange. Whether the expanded exception in § 1221(a)(3) is applicable is irrelevant because the sale or exchange prong would not be satisfied.[246]

Suppose now that A transfers all the U.S. patent rights for the remainder of its legal life to an unrelated party for cash. If this is the case, A should be entitled to capital gain treatment, provided § 1221(a)(3)(C) does not apply. In other words, A's basis in the patent is not "determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer . . . whose personal efforts create such property."[247]

Alternatively, suppose the assignment is only for the remaining legal life in the patent for the drug's ability to delay the onset of Alzheimer's disease. In this scenario, A would retain the patent rights concerning the use of the drug in its applicability to diminishing the effects of arthritis. Assume § 1221(a)(3) is inapplicable. While the issue is certainly not free from doubt, there is at least some authority that the field of use fragmentation would not result per se in ordinary income treatment. Moreover, consider the last fact-pattern involving a copyright, trademark, or trade name instead of a patent, where A does not retain "significant power, right, or continuing interest."[248] In the case of a trademark or trade name transfer, there is some strong authority that the field of use retention should not bar capital gain characterization.[249]

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246. Furthermore, because A is not an individual, it is not a "holder" as that term is defined in I.R.C. § 1235(b), so I.R.C. § 1235 is also not relevant.

247. I.R.C. § 1221(a)(3)(A), (C) (Westlaw through Pub. L. No. 115-281).

248. *Id.* § 1253(a).

249. *But see* Rev. Proc. 83-59, 1983-2 C.B. 575 *modified by* Rev. Proc. 2013-32, 2013-28 I.R.B. 55, *as superseded in part by* Rev. Proc. 2018-1 I.R.B 1 (stating the Service's public pronouncements *vis-à-vis* § 351 treatment where there is field of use fragmentation in a purported § 351 transfer with respect to these rights.). When it issued private letter rulings as to I.R.C. § 351 applicability, the Service required the taxpayer to represent that "[a]ll rights, title and interests for each copyright, in each medium of exploitation, will be transferred to the transferee." Rev. Proc. 83-59, 1983-2 C.B. 575. Regarding trademarks and trade names, the comparable representation was that "[t]he transferor will not retain any significant power, right, or continuing interest, within the meaning of section 1253(b) of the Code, in the . . . trademarks or trade names being transferred." *Id.* I.R.C. § 1253(b) does not specifically refer to a field of use retention as a significant power, right, or continuing interest. *See* I.R.C. § 1253(b). The Service will no longer rule on whether a transaction meets the requirements of § 351 but will rule on "significant" issues under I.R.C. § 351. *See generally* Rev. Proc. 2018-3, 2018-1 I.R.B. 130.

IV. ANALYSIS: SHOULD INTELLECTUAL PROPERTY LICENSE RIGHTS FALL UNDER § 351?

The Service's pronouncements requiring that all substantial rights be transferred and that the transfer constitute a sale or exchange pursuant to § 1222 is a blatantly inappropriate standard for determining whether the § 351 condition that "property [be] transferred to a corporation" has been met.[250] The transfer of an intellectual property license right should generally fall under that section's umbrella.[251] This is true whether or not it represents all substantial rights in the property in question, and assuming it in substance does not represent services rendered or to be rendered to the transferee corporation, and otherwise meets the requirements of § 351. It is unclear if the Service will continue to challenge a *DuPont* like fact-pattern. By not revoking and restating its guidance on this subject, the Service leaves taxpayers with unnecessary uncertainties.

As discussed above, a license right to intellectual property should, in general, constitute property as that term is used in § 1221 and therefore be a capital asset, unless it fits within one of the exceptions contained in § 1221(a), with § 1221(a)(3) generally being most problematic.[252] Thus, even if one subscribes to the notion that there should be parallel application of what is property pursuant to §§ 351 and 1221, license rights to intellectual property should normally not create a problem because it is generally considered property for purposes of both sections. Recall, in *DuPont*, the court pointed out that the government "*concedes that the license was 'property' in the hands of the transferee* but does not agree that [DuPont] gave up any 'property.'"[253]

This brings us to the action language, i.e., "transferred . . . in exchange for stock in such corporation"[254] in the case of § 351(a) and sale or exchange under § 1222.[255] Even if one ignores the vastly different

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250. As noted above, in Rev. Rul. 69-156, the Service indicated that "(t)he grant of patent rights to a corporation will constitute a transfer of property within the meaning of section 351 of the Code only if the grant of these rights in a transaction which would ordinarily be taxable, would constitute a sale or exchange of property rather than a license for purposes of determining gain or loss. In order for such a grant of patent rights to Y to constitute a sale or exchange, the grant must consist of all substantial rights to the patent." Rev. Rul. 69-156, 1969-1 C.B. 10.

251. The author recommends a Treasury Regulation or guidance from the Service denying § 351 treatment where the intellectual property right being transferred is of *de minimis* value in comparison to what is being retained, e.g., a six-month license on a patent with a twenty-year legal life.

252. *See supra* Part III.B.

253. E.I. du Pont de Nemours & Co. v. United States, 471 F.2d 1211, 1219 (Ct. Cl. 1973) (emphasis added).

254. I.R.C. § 351(a) (Westlaw through Pub. L. No. 115-281).

255. *Id.* § 1222.

purposes of § 351 and capital gain regime, the wording itself is dissimilar. Why should the same requirements apply to both provisions? The fact that § 351(a) (and § 721(a)) contains the word "exchange" should not require the same standards that apply to sale or exchange to be construed to apply to § 351 (or § 721). Receiving stock in return for a transfer of property is fundamentally different from a sale or exchange. The latter can apply, e.g., to a cash sale or an exchange of property to all types of assignees, but the former only applies where shares in a corporate transferee controlled by the transferor constitutes at least part of the consideration received.[256] The Court of Claims in *DuPont* arguably made every effort to rule in favor of the government by stating that "[w]ith some indulgence to defendant, we can count the language as basically neutral in itself."[257] The court, this writer contends, should have treated the different phrasing in the applicable provisions as another grounds for holding § 351 applied rather than treating it as a non-factor in the decision.

Aside from the different language used in § 351(a) (and § 721(a)) from that of § 1222, the purposes of the provisions are vastly different. In the words of *DuPont*, there is "a great variance between the purposes of section 351 and of the capital gains sections" including "the clear irrelevance of the concepts from the latter . . . to the goals and theory of the former."[258] The Court of Claims in *DuPont* was spot-on when it articulated that:

> [i]n other words, in this respect the capital gains concept of a "sale and exchange" is simply irrelevant to section 351, which has a quite different purpose and an independent postulate. To insist, nevertheless, on applying that alien notion is to bring about disparate results not rationally connected to the fundamental principle behind section 351 -- the paradigmatic example of "mechanical jurisprudence."[259]

The court in *DuPont* was correct in declining to saddle § 351 with the same requirements as the capital gain sale or exchange conditions simply because "the predecessors of section 351 and the capital-gain-and-loss provisions had their joint birth in the Revenue Act of 1921 where they were placed in very close proximity, and that this juxtaposition continued for many years."[260] The court argued that "[t]he elements of cognate origin and statutory juxtaposition are outbalanced by the great variance between the purposes of section 351 and of the

256. *See id.* §§ 351(a)–(b), 1222.
257. *DuPont*, 471 F.2d at 1214.
258. *Id.* at 1218.
259. *Id.* at 1217.
260. *Id.*

capital gains sections, and by the clear irrelevance of the concepts from the latter."[261]

The Court of Claims in *DuPont* quoted the tax court in *H.B. Zachary* regarding the different objectives of the statutory provisions, stating that "unlike 'the problems of capital gain versus ordinary income,' section 351 is 'concerned solely with the historic exemption of transfers to a controlled corporation where the taxpayer's interest in the property continues although the form of ownership is changed.'"[262] Both the differing purposes and language in these dissimilar tax regimes warrant that the sale or exchange conditions necessary for capital gain treatment do not serve to bind transfers intended to come within § 351.

V. AN EXCEPTION: § 351(d)(1)

An article addressing whether transfers of intellectual property license rights should come within § 351 would not be complete if it did not at least briefly examine the services exception in § 351(d)(1). Section 351(d)(1) provides that "[f]or purposes of this section, stock issued for . . . services . . . shall not be considered as issued in return for property."[263] This requirement is amplified in Treasury Regulation § 1.351-1(a)(1)(i), which provides that "[s]tock will not be treated as issued for property if it is issued for services rendered or to be rendered to or for the benefit of the issuing corporation."[264]

The demarcation between property and services in this regard is not always clear. One authority points out that:

> if the intangible property is created by a transferor, the distinction is often blurred between the transfer of the right in the intangible property and the transfer of services, especially when the intangible property has been created by the transferor specifically for a transferee in accordance with the transferee's specifications.[265]

In Revenue Ruling 64-56, discussed above, the Service stated that "where the information transferred has been developed specially for the transferee, the stock received in exchange for it may be treated as payment for services rendered."[266] The Service did acknowledge, however, in the ruling that "[w]here the transferor agrees to perform services in connection with a transfer of property, tax-free treatment

261. *Id.* at 1218.
262. *Id.* at 1217 (quoting H.B. Zachary Co. v. Comm'r, 49 T.C. 73, 80 (1967)).
263. I.R.C. § 351(d) (Westlaw through Pub. L. No. 115-281).
264. Treas. Reg. § 1.351-1(a)(1)(i) (as amended in 2016).
265. Rothman et al., *supra* note 185, § III.B.1.b.
266. Rev. Rul. 64-56, 1964-1 C.B. 133; *see also* Rev. Rul. 71-564, 1971-2 C.B. 179.

will be accorded if the services are merely ancillary and subsidiary to the property transfer."[267]

Furthermore, the reach of § 351(d) has been limited in this area. As Bristor, McGinley, and Leibler observe, "[t]ransferor-produced patents, copyrights, trademarks, and trade names are theoretically susceptible to the Section 351(d) services exception . . . both the IRS and the courts have declined to invoke the services exception with respect to these items."[268] Thus § 351(d) does not seem to apply where the shares are "issued for items of intellectual property that enjoy a well-defined base of legal protection . . . even though the property was created by the transferor."[269]

VI. CONCLUSION

Let us return to my original hypothetical where Corporations A, B, and C decide to form a corporate joint venture called Newco. Newco's objective is to manufacture and market a patented formulation whose main benefit is delaying the onset of Alzheimer's disease. Newco would also like to develop other pharmaceuticals in the future. B and C each contribute $1 billion to help fund manufacturing, distribution, future research and development, and other initial costs of the operations. Newco is a C corporation. A contributes the right to use its patent on the Alzheimer's drug for a period of ten years. Assume the patent has a legal life left of fifteen years. A retains all rights to the patent after the expiration of the ten years.

While the Service's public pronouncements would treat the hypothetical transfer as falling outside the scope of § 351(a), it should actually come within the parameters of this provision. The same is true for the alternative hypothetical where A transfers the patent rights for its full fifteen-year remaining legal life, but A retains all patent rights to use the drug with respect to its applicability to diminishing the effects of arthritis. In both scenarios, there is an overwhelming argument that § 351(a) should apply. In the latter fact-pattern, the Service's public pronouncements are perhaps even more egregious because the retention of the use of the patent in another field arguably may not prevent all substantial rights to the patent from being considered transferred.

In view of the stark differences in purposes of the provisions as well as their textual dissimilarities, there is a clear argument that the court in *DuPont* got it right. Bristor, McGinley, and Leibler wrote roughly fifteen years ago that "[i]t is somewhat disturbing that . . . taxpayers

267. Rev. Rul. 64-56, 1964-1 C.B. 133.

268. *See* Bristor, McGinley & Leibler, *supra* note 85, at 15.

269. *See* Fleming, *supra* note 32, at 116.

seeking to transfer intellectual property pursuant to one of the oldest nonrecognition provisions in the IRC cannot be certain of the tax consequences."[270] Taxpayers *should* have assurance through public guidance from the Service (or through Treasury Regulations) that if they meet § 351's other requirements (and in the absence of boot) intellectual property license rights can generally be transferred without gain recognition. Even if the Service is giving benign neglect to their earlier pronouncements in this area, by not aggressively challenging on audit § 351 capital contributions of intellectual property licenses, absent a statutory fix, the Service should modify prior administrative guidance to be consistent with *DuPont*. This would be harmonious with sound tax policy.

270. *See* Bristor, McGinley & Leibler, *supra* note 85, at 26.