Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

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Refer Reply To:
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Date:
June 8, 2001

In re:

LEGEND

Taxpayer	=
Country 1	=
Country 2	=
Licensor	=
Year 1	=
Year 2	=
Date 1	=
State	=
Company	=
a	=
b	=
c	=
d	=
e	=

Dear :

This letter responds to your letter dated February 6, 2001, submitted on behalf of Taxpayer, requesting a letter ruling under §§ 197 and 1235 of the Internal Revenue Code.

Taxpayer represents that the facts are as follows.

FACTS

Taxpayer is a corporation organized and existing under the laws of State. Taxpayer was incorporated in Year 1 . Prior to Year 2, . In Year 2, . .

, Taxpayer (including its subsidiaries) is engaged in .

In general, Taxpayer and its Group subsidiaries enter into licensing agreements with Licensor (or affiliates of licensor) for the use of applicable trademarks, trade names, and/or technology in manufacturing, marketing, distributing, and selling various products.

Licensor's technology is . Licensor's technology is proprietary to Licensor, and its confidentiality is closely guarded through non-disclosure agreements with employees and suppliers.

, Licensor provides equipment used by Group in its laboratories. However, the bulk of Group's equipment is purchased from . .

In Date 1, Group purchased the stock of Company and its subsidiaries (Acquired Group). Following the acquisition, an Acquired Group member entered into a technology agreement with Licensor giving it access to Licensor's technology for use in producing and distributing Acquired Group products in Country 1. The initial technology agreement between Acquired Group and Licensor was terminated by agreement of the parties. Taxpayer and Licensor wish to enter into a new technology agreement (Technology Agreement) which will provide Taxpayer with continuing and expanded access to Licensor's technology for use in connection with Acquired Group's products.

Under the Technology Agreement, Licensor will grant Taxpayer the right to use the Technology (as defined in the Technology Agreement) on an exclusive basis in the Territory (as defined in the Technology Agreement), subject to the existing rights of certain Licensor affiliates therein; and the exclusive right to import, manufacture, market, distribute, and sell the Licensed Products (as defined in the Technology Agreement) in the Territory.

The Technology Agreement will provide, in part, that the present license is personal to Taxpayer with respect to the manufacturing, marketing, distribution, and selling of the Licensed Products in the Territory. Taxpayer must use it itself and may not, except as specifically provided in the Technology Agreement, transfer the license to a third party in any way, or sub-grant or sub-contract it in whole or part, under penalty of termination. Notwithstanding the foregoing, Taxpayer will have the right, without the consent of Licensor, to grant distribution rights (including the right to grant sub-distribution rights to Taxpayer's affiliates), exclusively or otherwise, to its affiliates, providing each grant (including sub-grants) is made expressly subject to the Technology Agreement and Licensor's rights thereunder.

In consideration of the rights granted under the Technology Agreement and the services to be rendered thereunder, Taxpayer will pay a royalty to Licensor of e percent of net sales of Licensed Products for the right to use the Technology and the technology-related services to be performed. In the event that Taxpayer will sublicense the use of the Technology to third parties other than its affiliates, it will pay a royalty to Licensor of b percent of net sales acheived by the third party sublicensees with Products (as defined under the Technology Agreement) based on the Technology.

The Technology Agreement will continue for a specified period, unless earlier terminated. The Technology Agreement will be renewed for successive periods of b years each, unless either party objects to the renewal by registered letter sent to the other party at least d months prior to the expiration of the current term.

In addition, Taxpayer makes the following representations: 1) The entering into of the Technology Agreement will not be part of a broader transaction that constitutes the acquisition of a trade or business; 2) the Licensed Technology or a substantial portion thereof has significant application in the industry beyond the manufacture of the Licensed Products; 3)
; 4) none of the intangibles subject to the Technology Agreement are customer-based intangibles; and 5) the Licensed Technology has significant application in areas outside of Country 1.

RULING REQUESTED

Taxpayer requests the Service to rule that the payments made by Taxpayer to Licensor pursuant to the Technology Agreement will not be chargeable to capital account under § 197, and will be currently deductible.

LAW AND ANALYSIS

Section 197(a) provides that a taxpayer shall be entitled to an amortization deduction with respect to any "amortizable section 197 intangible." The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining

gain) of the intangible ratably over a 15-year period beginning with the month in which the intangible was acquired.

Section 197(c) generally defines the term “amortizable section 197 intangible” to mean any § 197 intangible that is acquired by the taxpayer after the date of enactment of § 197, and held in connection with the conduct of a trade or business activity described in § 212.

Section 1.197-2(a)(3) of the Income Tax Regulations provides that § 197 does not apply to amounts that are not chargeable to capital account under § 1.197-2(f)(3) (relating to basis determinations for covenants not to compete and certain contracts for the use of § 197 intangibles) and are otherwise currently deductible.

Section 1.197-2(f)(3)(iii) provides that the transfer of a right or term interest described in § 1.197-2(b)(11) (relating to contracts for the use of, and term interests in, § 197 intangibles) by the owner of the property to which such right or interest relates but not as part of a purchase of a trade or business will be closely scrutinized under the principles of § 1235 for purposes of determining whether the transfer is a sale or exchange and, accordingly whether amounts paid on account of the transfer are chargeable to capital account. If under the principles of § 1235 the transaction is not a sale or exchange, amounts paid on account of the transfer are not chargeable to capital account under § 1.197-2(f)(3).

Section 1235(a) provides that a transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of 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.

Section 1.1235-2(b)(1) defines the term “all substantial right to a patent” to mean all rights (whether of not then held by the grantor) which are of value at the time the rights to the patent (or undivided interest therein) are transferred. The term "substantial rights" 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 the 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.

Section 1.1235-2(b)(2) provides that rights which are not considered substantial for purposes of § 1235 may be retained by the holder. Examples of such rights are: (i) The retention by the transferor of legal title for the purposes of securing performance or payment by the transferee in a transaction involving a transfer of an exclusive license to manufacture, use, and sell for the life of the patent; and (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.)

Section 1.1235-2(b)(3) provides that examples 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, are: (i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee; and (ii) The failure to convey to the transferee the right to use or to sell the patent property. Section 1.1235-2(b)(4) provides that the retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of § 1235.

The Technology Agreement will be for a stated period with tacit renewal periods, unless either party objects in writing. Under these terms, Licensor will retain the power to terminate the transfer at will after the initial term of the Technology Agreement. Also, by virtue of its retained power to determine the identity of any sublicensee and to dictate as well the terms and conditions of any sublicense, Licensor controls, and indeed may prohibit, sublicensing by Taxpayer. In addition, the rights conveyed by the Technology Agreement are geographically limited. Thus, applying the principles of § 1235 to the Technology Agreement, we conclude that the Technology Agreement will not constitute a transfer by Licensor to Taxpayer of all substantial rights to the property that is the subject of the Technology Agreement.

Accordingly, based on the foregoing analysis and the representations made by Taxpayer, we rule that the amounts paid by Taxpayer to Licensor pursuant to the Technology Agreement will not be chargeable to capital account under § 197, pursuant to § 1.197-2(f)(3)(iii), and will be currently deductible. No opinion is expressed on the correctness of whether the amounts to be paid by Taxpayer to Licensor under the Technology Agreement represent arm's-length consideration.

In accordance with the power of attorney filed with this request, we are sending a copy of this letter ruling to Taxpayer and Taxpayer's second authorized representative.

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

Sincerely,

Harold E. Burghart
Assistant to the Chief, Branch 5
Office of Associate Chief Counsel, Passthroughs and Special Industries)

cc: