Office of Chief Counsel
Internal Revenue Service

Memorandum

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date: January 31, 2013

to: Revenue Agent (LB&I),

from: Associate Area Counsel (LB&I),

subject: **Amortization of Patents** **UIL = 197.00-00**

You are currently examining the for the year ended . The issues are:
(1) Is the corporation entitled to a deduction for the amortization of certain patents acquired by the company from its principal shareholder, (2) are monthly payments by the company to that shareholder deductible on the corporate return, and (3) are said payments income or capital gain to the shareholder and, if capital gain, is it long-term or short-term?

This memorandum was informally coordinated with Chief Counsel Attorneys John Oldak (Income Tax and Accounting) and James Holmes (Passthroughs and Special Industries).

This advice responds to your request for assistance. It may not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Facts

("the corporation") is a corporation in the business of .
The corporation was incorporated under the laws of .

During the year , shares were held by ("the shareholder," "the individual," or "the transferor") and others. Specifi-cally, the individual owned The individual was, at that time, a resident of . In , the corporation signed an agreement to purchase, in installments, all shares other than those belonging to the individual. The individual was a director of the corporation at all relevant times.

Prior to , the shareholder was the owner of patents, all of which could be useful in the corpora-tion's business. The shareholder obtained these patents as their inventor.

In a document entitled " ," dated , the shareholder assigned to the corporation " " the inventions listed in the attached . Those patents were U.S. Patents numbered ("the patents"). In addition, the Patent Assignment Agreement states that the shareholder "

." In return for this assignment, the corporation agreed to pay the shareholder $ per year for years, in payments of $ per , commencing on and ending on . This agreement states that it "shall be governed and construed under the laws of the State of ."

On , the shareholder unilaterally executed a document entitled " ," in which he, "

"

The payments required by the Agreement

were made without fail on the dates specified. These payments were recorded in the corporate books and tax returns as deductible expenses when paid. They were recorded, however, not as payments connected in any way with patents, but as "directors' fees." The patents themselves were not listed on the corporate balance sheet and no amortization or depreciation deductions were taken in connection with those patents. Other patents owned by the company were amortized.

On the shareholder's tax returns, the receipt of these monthly payments were recorded as capital gain from the sale of patents. The entire payment was reported as gain with no deductions, i.e., the transaction was treated as if the patents were sold to the corporation with zero basis and no associated expenses.

On , a document entitled " " was executed by the corporation and the shareholder. In this document, in wording very similar to the agreement, the shareholder assigned to the corporation " " in the same patents that were assigned in . In return, the corporation agreed to pay the shareholder $ per year for years, in payments of $ per , commencing on and ending on . [Note that the time between these dates is only years.]

For the year commencing on and ending on –- the only corporate year currently under examination-- you propose to disallow the deduction of the $ -per- payments. You propose to allow the corporation a deduction for amortization in that year as if the patents were amortized on a schedule beginning on . You have also asked if the capital gain reported on the shareholder's individual return can be deemed "long-term" under Sec. 1235(a), regardless of how long the shareholder held the patents before assigning them to the corporation.

The taxpayer has argued that the agreement of , was not a sale of the patents but was intended to be a licensing agreement. The taxpayer states that, as royalties paid by the corporation to the shareholder, the $ -per- payments are deductible when paid.

Issues and Answers

(1) Is the corporation entitled to a deduction based on the amortization of patents acquired from its principal shareholder? (Yes)

(2) Is the corporation entitled to deduct the install- ment payments made to acquire said patents? (No)

(3) Should the individual/shareholder report ordinary income or capital gain and, if the latter, long-term or short-term? (Capital gain; term depends on whether patents were held by the seller for one year or more)

Analysis

In your examination, the corporation and the individual shareholder have taken inconsistent positions in their returns. If the individual sold patents to the corporation, with the purchase price to be made in installments over time, then the corporation should have taken deductions for the amortization of those patents as their owner; no corporate deductions would have been triggered by the installment payments made to the seller. The individual, as seller of the patents, should have reported capital gain on his tax return. On the other hand, if the individual had merely licensed the patents to the corporation, then the corporation would take deductions for the licensing fees (royalties) when paid; but the individual return would report ordinary income from such fees when received. In your case, however, the corporation and the individual have taken the best of both worlds: The corporation deducted the payments when paid (as if it were a license) and the individual reported those receipts under the more favorable capital gains treatment (as if it were a sale). Under no circumstances can this inconsistency be allowed to stand.

Issues One and Two: Amortization or Royalties Paid Deduction?

We believe that the documents of , are explicit and are controlling. According to those documents, the shareholder sold patents to the corporation on that date. Commencing on that date, the proper tax treatment of those patents would have been to list them as assets on the corporate balance sheet and to deduct an appropriate amount as amortization. (See Reg. Sec. 1.263(a)-4(c)(1)(vii), which states that acquired patents shall be capitalized.) The patents would be depreciated under I.R.C. Sec. 167(f)(2) either ratably over their remaining useful lives or using the income forecast method. (See Reg. Sec. 1.167(a)-14(c)(4), providing that if the purchase price of an interest (other than an interest acquired as part of a purchase of a trade or business) in a patent is not payable on at least an annual basis as either a fixed amount per use or a fixed percentage of the revenue derived from the use of the patent, then the basis of such patent is depreciated either ratably over its remaining useful life or under I.R.C. Sec. 167(g)(the income forecast method)).[1]

The corporation, however, argues that the substance of the transaction on , was a licensing agreement, not a sale, and that the monthly payments were therefore royalties, deductible as a corporate expense.

Analysis of the taxpayer's argument requires a knowledge of both tax law and contract law. It has long been held that, having organized his affairs as he chooses, a taxpayer must accept the tax consequences of his choice and may not enjoy the tax benefits of some other route he may have chosen but did not. Commissioner v. National Alfalfa Dehydrating & Milling Corp.,

[1] I.R.C. Sec. 197 also makes some provisions for the amortization of goodwill and other intangibles, including patents. See Secs. 197(a) and 197(d)(1)(C)(iii). Section 197 does not apply, however, to patents that are acquired by a taxpayer in anything other than a transaction involving the acquisition of assets constituting a trade or business or a substantial portion thereof. See Sec. 197(e)(4)(C). In your examination, the corporation acquired the patents alone from the individual, not as part of the acquisition of a trade or business; Sec. 197 therefore does not apply.

Note also that Reg. Sec. 1.167(a)-14(c)(4) provides that, under certain circumstances, if the purchase price of a patent is paid in installments, those installments may be deducted as depreciation in the year paid, but only if the purchase price of the patent is payable on at least an annual basis as either a fixed amount per use of the patent or a fixed percentage of the revenue derived from use of the patent. In your case the sale price was a flat amount, independent of the patent's use or revenues; therefore, the installment payments are not deducted as depreciation in the year paid.

Further, Reg. Sec. 1.167(a)-3(b) provides a 15-year useful life for certain intangibles. However, this 15-year useful life does not apply to an intangible asset described in Reg. Sec. 1.263(a)-4(c) or to an intangible asset with a useful life the length of which can be estimated with reasonable accuracy. (See Reg. Sec. 1.167(a)-3(b)(1)(ii) and (iii). Therefore, the 15-year useful life provided by Reg. Sec. 1.167(a)-3(b) does not apply to the patents at issue in your examination.

417 U.S. 134 (1974); Estate of Durkin, 99 T.C. 561 (1992); Grojean v. Commissioner, 24 F.3d 572 (7th Cir. 2001); Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967). As the court stated in Estate of Bean v. Commissioner, 268 F.3d 553, 557 (8th Cir. 2001), "once chosen, the taxpayers are bound by the consequences of the transaction as structured, even if hindsight reveals a more favorable tax treatment." See also Bradley v. United States, 730 F.2d 718 (11th Cir. 1984). Under this principle, the corporation in your examination may not now re-cast its purchase of the patents as if it were a licensing agreement even though, in hindsight, that appears to be a more favorable transaction, and even if both parties to the contract (the corporation and the shareholder) consent to such a retroactive re-writing of history. The parties, having agreed to a sale in , cannot now change that transaction into something it was not: A licensing agreement. They must live with the consequences of the transaction as it actually was, even if they both now prefer that it had been something else.

The general rule of contract law is that "if the terms of a contract are clear and unambiguous, the contract will be enforced or given effect in accordance with its terms, and without resort to construction to determine the intention of the parties . . . When the language of a contract is plain, there can be no construction because there is nothing to construe. . . It is not necessary to resort to a rule of construction to ascertain the meaning of a [contract] where the intent of the parties may be gathered from the terms actually expressed in the writing itself." In re Estate of Lewis v. Godfrey, 492 SW2d 385 (Mo. App. St. Louis District, 1973)

These principles have been upheld countless times. In Nation-Wide Check Corporation v. Robinson, 479 SW2d 192 (Mo. App. St. Louis District, 1972), the court held that a contract clause holding an agent responsible for any loss other than that resulting from robbery or burglary was unambiguous and not overly broad; the agent was liable for loss due to fire. The court stated that "a court will not resort to construction where the intent of the parties is expressed in clear and unambiguous language for there is nothing to construe." In J.E. Hathman, Inc. v. Sigma Alpha Epsilon Club of Columbia, Missouri, 491 SW2d 261 (Mo., 1973), the court held that a contract which stated that the "maximum cost" was "estimated" and "adjustable" meant just that; i.e., it was not an absolute and inflexible maximum. The court stated that "the cardinal rule in the interpretation of a contract is to ascertain the intention of the parties and to give effect to that intention. Where there is no ambiguity in the contract the intention of the parties is to be gathered from it and it alone. . . A court will not resort to construction where the intent of the parties is expressed in clear and unambiguous language for there is nothing to construe. . . . It is only where the contract is ambiguous and not clear that resort to extrinsic evidence is proper to resolve the ambiguity.” In Eisenberg v. Redd, 38 SW3d 409 (Mo. 2001), the court held that the words “law firm” can only have one meaning, concluding that “a contract is ambiguous only if its terms are susceptible of more than one meaning so that reasonable [persons] may fairly and honestly differ in their construction of the terms. . . . If there is no ambiguity . . . the intent of the parties is determined from the four corners of the contract.” See also Jake C. Byers, Inc. v. J.B.C. Investments, 834 SW2d 806 (Mo. App. 1992); 17 C.J.S. Contracts, Sec. 321; 12 Am. Jur. Contracts, Sec 229.

Under these principles, an unambiguous contract is enforceable according to its terms, even if both parties to the contract later claim that they intended something other than the words of the contract. The words of the contract themselves express the intent of the parties; contrary evidence is not admissible. This rule is necessary to preserve the integrity of written contracts: If a party to a contract could bring in evidence that contradicts the plain written meaning of a contract, there would be little reason to put contracts in writing at all. Business would be greatly disrupted if no party to a contract could be certain that it means what it says.

In the general usage of patent law, an “assignment,” without any limitation, is the complete transfer of ownership in the patent. This is distinguished from a “license,” which “is not an assignment of any interest in the patent. The licensee does not acquire legal title to the patent right.” 60 Am.Jur.2d, Patents, Sec. 1198. A license is defined as “any transfer of patent rights short of assignment.” Wayman v. Louis Lipp Co., D.C.Ohio 222 F.679, 681. An assignment, if not limited on its face, conveys “the exclusive right to make, use, and vend the entire invention.” 60 Am.Jur.2d, Patents, Sec. 1167.

In the current examination, the “ ” is a contract for the sale of the patents; the “ ” effects an actual transfer of the patents in fulfillment of that contract. The two documents could not be more unambiguous. The documents are in good legal form and appear to have been professionally drafted. The contract plainly states that the “ ” in the patents at issue are “assigned” to the company. The “ ” states that the shareholder “ , ” in the patents. The (contract) states that this is done “ ” of $ per year for years. The contract sets forth a “ ” of $ per for years, but in no way suggests that the assignment or sale of the property is a transfer only for the year period, with the property to revert to the shareholder after that time. The contract does not contain the words “license,” “royalty,” “rent,” or “use,” (or any form of those words) as would be expected in a licensing agreement. The contract is unambiguously an installment sale and a complete transfer of the patents to the corporation.

In making its arguments, the corporation might refer to the sale document of , in which the shareholder sells for a second time the patents that it sold years earlier. The corporation could argue that this second document indicates its belief that the document was a license, with the latter document as a subsequent license or extension of the first license on the same property. This is the very type of evidence, however, that is inadmissible, as it is contrary to the unambiguous contract language of that indicates that the patents were sold.

Even if evidence contradicting the sale documents of , were considered, we conclude that the transaction in your examination was a sale and not a license. It is well recognized that the name given to an agreement is not conclusive as to the substance of the transaction. Waterman v. Mackenzie, 138 U.S. 252 (1891). Where it appears from all the evidence that the parties intended a transfer of all rights in and to an asset, such intention will be given effect. Bell Intercontinental Corp. v. United States, 180 Ct. Cl. 1071, 381 F.2d 1004 (1967). Where less than all rights to an asset are transferred, there may be only a license, not a sale. Walen v. United States, 273, F.2d 599 (1st Cir. 1959). In Consolidated Foods Corp. v. United States, 569 F.2d 436, 437 (7th Cir. 1978), the Court stated that the basic problem is to determine the extent to which the transferor retains propriety rights in the transferred assets. If the transferor retains sufficient proprietary rights, the transfer must be considered a license rather than a sale. In James O. Tomerlin Trust, Transferee v. Commissioner, 87 T.C. 876 (1986), the Court concluded that there was a sale rather than a license of a trademark where the Court found that the grant of the trademark was exclusive, worldwide, and forever, so long as the transferee made the required production payments, that the transferor was required to transfer legal title to the trademark to the transferee after the transferee made specified production payments, that the transferor had no right to terminate the agreement except upon the failure of the transferee to make the required periodic payments, and that these termination rights no longer applied after the transfer of the title of the trademark.

As explained above, it is clear that the and of , on their face, transferred all rights in the patents without limitation. In subsequent years, the corporation used the patents without limitation, which is an indication of ownership; the corporate books during those years did not record the payment of licensing fees on these patents; nor did the individual report royalties received. There is no written evidence prior to that either the corporation or the individual intended anything other than a sale on the installment method. In fact, the corporation apparently used the patents during the period between and , despite the lack of additional consideration for use of the patents during that time; such use is consistent with corporate ownership, not licensing. Only sometime after the flow of installment payments expired did the parties produce a second transfer document. Interestingly, this later document (the " ," dated) is also worded as a sale, and provides no evidence that a license was intended at that time, nor that a renewal of a supposed earlier license was intended. There is nothing in the record, other than the taxpayer's representative's current unsworn statement, that a license of these patents was ever intended. We conclude that the weight of credibility, given all the evidence, indicates that an installment sale was the intention of the parties on .

Issue Three: Individual Reporting

The individual in his return reported a gain on the sale of his patents to the corporation. As explained above, the patents were sold; therefore a capital gain (or loss) is the appropriate treatment. See I.R.C. Sec. 1221.

I.R.C. Sec. 1235(a) provides that some sales of patents shall be considered as generating long-term capital gains to the seller even if the patent was held by the seller for less than one year.[2]

I.R.C. Sec. 1235(d), however, states that the long-term capital gain treatment provided in Sec. 1235(a) shall not apply if the sale was between certain "related persons." Under I.R.C. Sec. 267(b)(2), such related persons include an individual and a corporation 25% or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. Under Sec. 1235(d)(2) and 267(c), "indirect ownership" of stock includes stock owned by the individual's spouse, ancestors, and lineal descendants.

In your examination, at the time of the transfer of the patents from the individual to the corporation, the individual owned

. The individual and together owned 25% or more of the shares by value. The individual and the corporation were thus "related parties" as defined by Sec. 1235(d). It follows that Sec. 1235(a) does not apply to the patent sale at issue here.

Where Sec. 1235(a) does not apply, the general rule of Sec. 1222 applies. This section defines short-term capital

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[2] Specifically, I.R.C. Sec. 1235(a) states:

> (a) A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent . . . by any holder shall be considered the sale or exchange of a capital asset held for more than one year [i.e., long term], regardless of whether or not payments in consideration of such transfer are
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> (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.

loss as the "loss from the sale or exchange of a capital asset held for not more than one year . . . " We conclude that the gain on the sale of the patents at issue in your case must be determined under this rule.

Conclusion

We conclude that the corporation is entitled to a deduction for the amortization of the patents under I.R.C. Sec. 167(f)(2) and Reg. Sec. 1.167-14(c)(4) either ratably over their remaining useful lives as of , or using the income forecast method under I.R.C. Sec. 167(g). The corporation is not entitled to deduct the payments that it made to the shareholder, as these payments were made to acquire a capital asset and not as the payment of royalties. The shareholder must report his gain (or loss) from this sale transaction; whether it is long-term or short-term depends on how long he held the patents before the sale.

We note that this examination may also raise issues regarding the change of accounting method under I.R.C. Secs. 446(e) and 481(a). If you wish to receive advice on that subject, please make an appropriate written request.

If you have any questions, please contact the undersigned at .

Associate Area Counsel (LB&I)

By: ______________________________

Attorney