Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

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May 31, 2001

Legend

Taxpayer :
Product:
Consultant :
Investor :
Company 1:
Country:
Partnership:
Marketer:
Company 2:
Daughter 1:
Daughter 2:
Year 1:
Year 2:
Year 3:
Year 4:
Year 5:
Year 6:
Year 7:
Year 8:
Date 1:
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Dear

We received your letter, dated September 14, 2000, requesting a ruling that Taxpayer's pre-transfer status as a "holder" under §1235 of the Internal Revenue Code will be retained following the transfer of his entire interest in certain patents to a newly formed limited liability company (LLC) in exchange for a membership interest in the LLC. In letters dated November 1, 2000, December 4, 2000, December 22, 2000 and January 12, 2001, additional information was submitted regarding Taxpayer's request.

Beginning in Year 1, Taxpayer, an independent inventor, began to develop Product. Between Year 4 and Year 8, The United States Patent Office issued to Taxpayer several patents related to Product. Currently, Taxpayer is contemplating filing additional U.S. patent applications for Product. Taxpayer was issued a foreign patent from Country on Date 14 and other applications corresponding to the U.S. patents have been or are being filed in industrialized countries throughout the world. The Product related patents and patent applications are referred to collectively hereinafter as the "Patents."

Taxpayer represents that by August of Year 4 basic Product functionality, the subject of the first Patent, had been tested and operated successfully under operating conditions and thus, Product had actually been reduced to practice within the meaning §1235 of the Code. Taxpayer also represents that in Years 5 through 8, subsequent related inventions were reduced to practice and additional patents obtained.

During the Years 2 through 7, Taxpayer represents that he invested $b in Product.

In order to obtain technical and financial assistance in developing and marketing Product, the Taxpayer entered into several agreements.

On Date 1, Taxpayer entered into a Consulting Agreement with Consultant pursuant to which Consultant agreed to provide services to Taxpayer in connection with the Product. As compensation for his services, Taxpayer agreed to pay Consultant $c per hour. By subsequent amendments, Consultant was given a right to a percentage of certain amounts received by Taxpayer from licensing Product.

On Date 2, Taxpayer entered into an Invention Exploitation Agreement with Investor pursuant to which Investor agreed to fund up to d% of the costs of the Product in exchange for up to d% of the income after recovery of expenses. By Year 7, Investor had contributed $e towards the cost of the Product and that amount had been repaid from the proceeds received from Company 2.

Between Year 5 and Year 6, Taxpayer engaged in discussions with Company 1 concerning Company 1's interest in obtaining an exclusive license for all Patents and products relating to Product. Although no formal agreement was concluded, Company 1 funded $f of Taxpayer's Product related costs. In addition, Company 1 spent substantial amounts on its own in an effort to develop parts for Product and to understand the market. When Company 1 decided in Year 6 to abandon its Product related project, Company 1's work product, including a patent that it had obtained, was assigned to Taxpayer pursuant to an Agreement dated Date 4 between Company 1 and Taxpayer.

On Date 5, Taxpayer entered into a Royalty Participation Agreement with Partnership pursuant to which Partnership agreed not to claim any infringement of a U.S. patent as a result of Taxpayer's development and exploitation of Product. Partnership's patent was for its invention of a similar type product. In return for Partnership's agreement, Taxpayer agreed to pay Partnership g% of the royalties that Taxpayer received from the U.S. exploitation of Product.

On Date 9 and Date 10, Taxpayer and Marketer entered into an Agreement relating to Product pursuant to which Marketer agreed to provide certain assistance in finding a licensee to market Product in return for graduated payments of between h% and i% of the net royalties received by Taxpayer from any licensee introduced by Marketer.

On Date 11, Taxpayer entered into a Preliminary License Agreement with Company 2, a Foreign corporation, pursuant to which Company 2 made an initial non-refundable royalty payment of $j. On Date 12, Taxpayer and Company 2 entered into a superceding License Agreement pursuant to which Taxpayer granted Company 2 an exclusive Foreign license to make, use or sell products covered by the Foreign patents and patent applications relating to Product for the life of such patents. In return for such licenses, Company 2 (i) paid Taxpayer an advance royalty in the amount of $k, $l of which is held in an escrow account and is refundable if Company 2 is unable to obtain the required approval of the Foreign Ministry of Health and Welfare, and half of which is creditable against the percentage royalties, and (ii) agreed to pay royalties ranging between g% and m% of the net selling price of licensed products, subject to

certain minimums.

In Year 2 and Year 3, Taxpayer transferred certain interests in the Patents to Daughter 1 and Daughter 2. In Year 2, Taxpayer represents that he made oral gifts of an undivided n% participation interest in the net positive cash flow from Product to each of Daughter 1 and Daughter 2. In Year 3, Taxpayer represents that he made additional oral gifts of p% interests to Daughter 1 and Daughter 2. Taxpayer acknowledged the Year 2 and Year 3 gifts to Daughter 1 and Daughter 2, and summarized the status of the Product in letters dated Date 3, Date 6, Date 7, Date 8 and Date13.

As of Date 15, Taxpayer has a U.S. Patents relating to Product that were issued to him during the period, Year 4 through Year 8. He also has one U.S. patent acquired from Company 1 that is relevant to Product. Taxpayer is currently pursuing foreign patents in r foreign jurisdictions that are applications corresponding to g of his U.S. Patents. To Date, the number of foreign patents issued to Taxpayer is h.

Taxpayer represents that, in a transaction qualifying under § 721, Taxpayer and his daughters will transfer their interests in Product, including, without limitation, all of their interest in the Patents and in the trade secrets, know how and other intellectual property associated with Product, to a newly formed limited liability company (LLC) in exchange for membership interests in LLC. The sole members of the LLC would be Taxpayer, who would have a q% interest in both capital and profits, and his two daughters, each of whom would have a i% interest in capital and profits corresponding to their existing i% participation in net positive cash flow. LLC would be manager-managed, with Taxpayer as the manager.

Taxpayer requests a ruling that (a) following the transfer of his interest in the Patents to LLC, Taxpayer will retain his status as a “holder” for purposes of §1235 of the Code and (b) assuming the other requirements of § 1235 are satisfied, Taxpayer’s share of any gain recognized by LLC on disposition of all substantial rights in the Patents will qualify under § 1235 as long term capital gain.

Section 1235(a) of the Code 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 1235(b) provides that, for purposes of § 1235, the term “holder” means–(1) any individual whose efforts created such property, or (2) 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, if such individual is neither–(A) the employer of

such creator, nor (B) related to such creator (within the meaning of subsection (d))

Section 1.1235-2(d)(2) of the Income Tax Regulations provides that although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership. For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partner's distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977: 9 months for taxable years beginning in 1977).

Section 1.1235-2(e) provides that, for purposes of determining whether an individual is a holder under paragraph (d) of this section, the term "actual reduction to practice" has the same meaning as it does under § 102(g) of title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs.

Section 301.7701-3(b)(1)(i) of the Procedure and Administration Regulations provides that a domestic eligible entity (a business organization not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5),(6), (7), or (8)) with two or more owners is treated as a partnership for tax purposes unless the entity elects to be treated as a corporation.

In the present case, the LLC formed by Taxpayer and his daughters would be classified as a partnership for federal tax purposes under § 301.7701-3. Consequently, LLC would be classified as any other partnership for purposes of § 1235 and the regulations under § 1235.

Based on the information submitted and the representations made, we conclude that (a) following his transfer of his interest in the Patents to LLC, Taxpayer will retain his former status as a "holder" for purposes of § 1235; and (b) provided the other requirements of § 1235 are satisfied, Taxpayer's share of any gain recognized by LLC on a disposition of an interest in the Patents will qualify under § 1235 as long term capital gain.

Except as specifically set forth above, we express or imply no opinion regarding any Federal tax consequences of the facts of this ruling request under any other provisions of the Code. In particular, we express or imply no opinion concerning (a) Taxpayer's status as a holder before the transfer of the Patents to LLC; (b) whether the

Taxpayer's transfers of undivided interests in the net positive cash flow from Product to his daughters were effective under applicable law, or whether such transfers, if effective, created a partnership; (c) whether Taxpayer's grant of an interest in the Patents to his daughters constituted gifts for Federal gift tax purposes; or (d) the application of § 1235 to any person other than Taxpayer. In particular, we express or imply no opinion concerning whether Daughter 1 and Daughter 2, who acquired their interests in the Patents by gift, have "holder" status under § 1235. In addition, we express or imply no opinion concerning the Federal tax consequences of forming LLC.

Taxpayer must attach a copy of this ruling to each of his tax returns that includes income from LLC's disposition of an interest in the Patents.

This letter ruling is addressed only to the Taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with the ruling request, a copy of this letter has been sent to two of Taxpayer's authorized representatives.

Sincerely,
Christine Ellison
Chief, Branch 7
Office of the Assistant Chief Counsel
Passthroughs and Special Industries

Enclosure
Copy for § 6110 purposes