DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
ATTN:
FROM: Associate Chief Counsel, Income Tax & Accounting

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated October 10, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Charity =

C =

Date 1 =

Date 2 =

$a =

y years =

z years =

$b =

c% =

d% =

Date 3 =

$e =

$f =

$g =

$h =

i years =

ISSUES

1. If the sale of the contract rights at fair market value would have resulted in gain, would any portion of the gain be ordinary income or gain that was not long-term capital gain?

2. Even if the contract rights would have resulted in long-term capital gain if exchanged for cash or other property, is Taxpayer's method of valuation of the rights at issue correct?

CONCLUSIONS

1. Further development is necessary in order to decide this question. In particular, we are unconvinced that a recapture provision should not apply to reduce the amount of the contribution to Taxpayer's basis in the contract.

2. While we do not know the basis for the suggested valuation of the contribution, we urge you to closely examine this issue. For example, we note that in this industry, patents are often quickly superceded by new patents. The facts do not indicate the age of the patents which were given, but we are concerned about the potential for inflated valuation of this part of the gift. Furthermore, the short remaining life of the contract rights (i years) is another area of concern regarding Taxpayer's valuation.

FACTS

In Date 1, Taxpayer entered into a contract with Charity to fund general research activities of Charity. The contract specified that the activities funded would be in areas of research that were related to Taxpayer's different business activities. Taxpayer has represented that the primary focus of the research was new developments in C. C products were a "core business unit" of Taxpayer at the time it entered into the contract with Charity.

The contract between Taxpayer and Charity provided that Taxpayer would provide Charity with $a for research, over a period of y years from Date 1 to Date 2. In return, Charity granted numerous rights to Taxpayer, extending over a period of z years unless sooner terminated or renewed. The rights Taxpayer received pursuant to the contract are as follows:

1. An option for a stated period to acquire the exclusive, worldwide licensing and sublicensing rights to develop, make, use or sell certain technology resulting from the general research over the z year period. In order to exercise this right, Taxpayer agreed to pay Charity an initial license fee and royalties based on net sales. Any sublicensees of Taxpayer would also pay Charity under a similar arrangement, as if Taxpayer had made the sales. Taxpayer's licensing rights were transferable subject to prior consent of Charity. Charity reserved the right to use any of the licensed subject matter for education and research without liability to pay royalties to Taxpayer or any sublicensees.

2. A right of first refusal to license certain products resulting from the general research, if Charity received a third party proposal to license those products. If Taxpayer did not license those products, Charity had to pay Taxpayer 5% of all royalties received by Charity from the third party licensee through a specified anniversary of the license.

3. Charity would provide lab and office space to Taxpayer at $b per square foot, per month. The facts do not indicate any restrictions to this right, so we assume the right was for the term of the contract.

In addition, it appears that the following items were a part of the general research contract between Taxpayer and Charity:

a. Taxpayer had the right, not to exceed three months, to enter into separate specific research funding contracts with Charity upon the request of Charity. The specific research contracts also had the potential to result in development of products and technology which could benefit Taxpayer's businesses. If Taxpayer declined and Charity was offered funds from a third party, Taxpayer had a right of first refusal and could reconsider its funding decision.

b. If Taxpayer did not exercise its right of first refusal under (a) above, and Charity entered into a specific research funding agreement with a third party, Charity would pay Taxpayer a set percentage of all royalties received by Charity which resulted from products derived from the specific research. This amount was capped at an amount equal to the amount of any general research money which was also used in the project. If no general research money was used in a royalty producing project, Taxpayer would receive nothing. In either case, Taxpayer specifically retained no rights to any technology or products resulting from specific research which it did not fund.

c. Taxpayer could pursue a patent infringement suit in Charity's name and was entitled to keep c% of any judgment recovered.

d. Charity would provide Taxpayer with its annual scientific report each year, and disclose all research developments relating to certain of Taxpayer's businesses, including C products, that occurred during the term of the general research contract. Taxpayer had 3 months after disclosure to request that Charity file a U.S. patent application. If a patent application was filed, Taxpayer would reimburse Charity for costs associated with applying for the patent. Charity would retain title to the patent or any resulting technology from the patent, and Taxpayer would receive credits up to d% of royalties payable to Charity under any license Taxpayer had which was associated with the patent. These credits, subject to the d% cap, were specifically to reimburse Taxpayer for its costs in obtaining the patent.

e. If Charity did not choose to file a patent application under (d) above, Taxpayer could do so and Charity would assign, grant or license all of its rights in the patent to Taxpayer.

The contract further provided that if Taxpayer did not elect within the 3-month period under (d) above to have a patent application filed, Charity could license the technology to anyone, with an exception for technology or material relating to C products. Any technology or material relating to C products had to be made known to the general public, and Charity could not file any patent application with respect to the technology. The facts do not indicate any method by which Charity was required to make this information available to the public. Taxpayer appears to retain no rights in technology or intellectual property for which it does not choose to file a patent application.

From Date 1 to Date 2, Taxpayer provided the funding required under the contract. Taxpayer entered into several specific research contracts with Charity described in (a) above. The specific research projects resulted in several patents, but the facts are unclear as to which party to the contract applied for the patent application, and thus had rights in the patent.[1] Taxpayer did not exercise its option to enter into any licenses with respect to the patents.

Taxpayer amortized $a paid pursuant to the contract over the term of the contract. Field counsel informed this office by phone that Taxpayer elected to amortize the cost pursuant to § 174(b) of the Internal Revenue Code. In addition, Taxpayer claimed the § 41 research credit.

At some point during the term of the agreement, Taxpayer decided C products were no longer one of its "core business units". The C business unit was subsequently divested, and on Date 3, Taxpayer irrevocably assigned to Charity all of its contractual rights under the agreement and any rights it had to any property derived as a result of the agreement. The assignment specifically released Charity from its disclosure obligations. At the time of the assignment, Taxpayer's basis in the agreement was $e. Taxpayer claimed a deduction under § 170 of the Code for a charitable contribution valued at $f, consisting of $g, which Taxpayer claimed represented the fair market value of its remaining contract rights and $h, which Taxpayer claimed represented the fair market value of the "patent estate" derived from the research performed under the contract.

LAW AND ANALYSIS

Issue 1: If the sale of the contract rights at fair market value would have resulted in gain, would any portion of the gain be ordinary income or gain which was not long-term capital gain?

Section 170(a) of the Code provides a deduction for charitable contributions (as defined in § 170(c)) payment of which is made within the taxable year.

Section 170(c) of the Code provides, in pertinent part, that the term "charitable contribution" means a contribution or gift to or for the use of a corporation, trust, community chest, fund, or foundation organized or created in the United States and operated exclusively for charitable purposes.

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution, reduced as provided in § 170(e)(1).

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[1] However, since part of the charitable contribution deduction was claimed for the value of the gift of the "patent estate", we assume Taxpayer did file at least one patent application.

Section 170(e)(1)(A) of the Code provides that the amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the amount of gain which would not have been long term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution). Section 170(e) further provides "for purposes of applying this paragraph (other than in a case to which §§ 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a) or 1254(a) applies), property which is property used in the trade or business (as defined in § 1231(b)) shall be treated as a capital asset".

Section 1.170A-4(a)(1) of the Regulations explains that § 170(e) applies to the donation of "ordinary income property." Ordinary income property is defined in the regulations as property in which any portion of the gain would not have been long-term capital gain if the property had been sold by the donor at its fair market value on the contribution date. Section 1.170A-4(b)(1) of the Regulations.

Section 1245(a)(1) provides in relevant part that if § 1245 property is disposed of, the amount by which the lower of 3 alternate values exceeds the adjusted basis of such property shall be treated as ordinary income. The 3 alternate values are: 1) the recomputed basis of the property; or, 2) in the case of a sale, exchange or involuntary conversion, the amount realized; or, 3) in any other disposition, the fair market value of the property. Section 1245(a)(3) provides that "§ 1245 property" is, among other types of property, personal property that is or has been property of a character subject to the allowance for depreciation provided in § 167.

Thus, if § 1245 would have caused any amount of gain from a sale of the contract rights to be treated as ordinary income, the amount of the charitable contribution should be reduced in accordance with § 170(e)(1)(A).

Section 170(e) provides that for purposes of § 170(e), § 1231(b) property is to be treated as a capital asset. However, § 1245(d) provides that § 1245 "shall apply notwithstanding any other provisions of this subtitle[A]." Furthermore, relevant legislative history dating from the enactment of §§ 170(e) and 1245 indicates that Congress intended § 1245 to override "income characterization" provisions such as § 1231. S. Fin. Comm. Rpt. 87-1881, at 112, 113 (1962). Although § 1245(b)(1) provides that § 1245(a) shall not apply to transfers by gift, § 170(e) was enacted to act in tandem with the purposes of § 1245. Id. at 113-114.

In this case, you informed us by telephone that Taxpayer amortized the contract pursuant to § 174(b). We suggest you consider whether or not this was proper. If the contract rights at issue were of a character subject to the allowance for depreciation under § 167, § 1245 may be applicable despite the fact that Taxpayer amortized the contract under § 174(b). We further suggest you consider each contract right and patent separately in your analysis. Section 1.174-4(a)(2) of the Regulations provides that the election to treat research or experimental expenditures as deferred expenses under § 174(b) applies only to those expenditures which are chargeable to capital account but are not chargeable to property of a character subject to an allowance for depreciation or depletion under §§ 167 or 611, respectively. The regulation explains that this means that § 174(b) only applies if the property resulting from the research or experimental expenditures has no determinable useful life.

Additionally, we question whether Rev. Rul. 85-186, 1985-2 C.B. 84, which denies recapture with respect to amounts deducted in the development of an asset resulting from research and development expenditures under § 174, is applicable to the research contract in this case, which itself had a limited life and conferred significant rights. Rev. Rul. 85-186 concerned expenditures under 174(a) rather than amortization under 174(b). The ruling holds that the legislative purposes of § 174, which are to encourage research and eliminate the uncertainty of research expenditures, are accomplished in the year the deductions are allowed. In contrast, a sum of money paid in advance for research which simultaneously grants rights and privileges to the payor doesn't seem to us to be the same type of expenditure described in § 174(a) and discussed in the ruling. Also, as stated above, the issue remains as to whether the amortization under § 174(b) was proper.

We also think you should consider that even if the contract was properly amortizable under § 174 and thus arguably beyond the scope of § 1245, the research expenditures which are allocable to patents or any other property with a determinable useful life possibly should be separately amortized under § 167, pursuant to § 1.174-4(a)(2). This property would then be within the scope of § 1245 and thus a sale would have resulted in recapture of ordinary income. Thus, if the patents had a value, the amount of the charitable contribution would be reduced under § 170(e)(1)(A).

Issue 2: Even if the contract rights are a capital asset and not subject to recapture, is Taxpayer's method of valuation of the rights at issue correct?

As noted at the beginning of this memo, we urge you to closely examine this issue. For example, we note that in this industry, patents are often quickly superceded by new patents. The facts do not indicate the age of the patents which comprise the "patent estate", but we are concerned about the potential for inflated valuation of this part of the gift. Furthermore, the short remaining life of the research contract rights (i years) is another area of concern regarding Taxpayer's valuation. We think you should consider whether the contract rights could have been sold, or if anyone would have purchased the contract rights. If no willing buyer would have purchased i years of contract rights under these circumstances, the fair market value of the contribution may be $0. See § 1.170A-1(c) of the Regulations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Even if you decide the contract rights and patent rights at issue are capital and if sold would have resulted in capital gain to the Taxpayer, we think that the assets may be significantly overvalued. The contract was for z years; there are i years left on that contract. We urge you to contact of for further discussion on valuation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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