**677.01 What rights in Intellectual Property does a transferor have to convey to a business entity in order to avoid a taxable event under IRC Sections 351 or 721?**

The purpose of sections 351 and 721 is to facilitate the flow of “property” from persons to business entities that will use the property productively but does not close out the transferor’s investment.[[1]](#footnote-1) Although the Code does not define “property” for purposes of sections 351 or 721, the courts have given the term rather broad application.[[2]](#footnote-2) The term “property” for purposes of section 351 “encompasses whatever may be transferred.”[[3]](#footnote-3)

For years, the IRS asserted that IRC Section 351 (and therefore   
Section 721) does not apply to a transfer of patent (and other IP) rights unless the transaction would rise to the level of a sale or exchange under Section 1001. Thus, the transferor would have to give up “all substantial rights” to the patent.[[4]](#footnote-4) In Rev. Rul. 69-156, the IRS asserted the “all substantial rights” test 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 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.

According to the IRS, the retention by the transferor of substantial rights in the patent or other IP would constitute a license of IP rights and therefore not an exchange of property.  *Id*.  The IRS did not consider the transfer of a license to qualify as a transfer of “property” under Section 351 because a similar transfer to a third party would not constitute a sale or exchange pursuant to Section 1001 for purposes of realizing gain or loss on the transaction.

Based on its position, the IRS asserted a transfer of IP will qualify as a sale, as opposed to a license, only if the transferor assigns all substantial rights to the IP; and such assignment is equally required by sections 721 and 351.[[5]](#footnote-5)

The IRS asserted its “all substantial rights” argument to the Court of Federal Claims in 1973 and lost.[[6]](#footnote-6) In that case, Du Pont was engaged in the domestic sale and exportation (to France, among other places) of urea herbicides. Du Pont organized a wholly-owned French subsidiary, Du Pont de Nemours (France) S.A., to manufacture the herbicide in France. Du Pont granted to the subsidiary a royalty-free, non-exclusive license to make, use and sell urea herbicides under the French patents. Du Pont gave up its right to assert patent infringement against the subsidiary's products for the duration of the license, which was for the remaining life of the patents. The subsidiary had the right to sublicense manufacturing for its own needs, but any other sublicensing could only be done with the parent's consent. In exchange for this grant, and in lieu of royalties, Du Pont received stock in the subsidiary valued at $411,500.

The IRS argued that “[s]ince all substantial rights of the patents will not be transferred \* \* \* to the new French company, such patents will not be considered property within the meaning of section 351 \* \* \*.”[[7]](#footnote-7) According to the Court of Claims, the IRS focused on the “exchange” requirement contained in Section 351, with that factor being equated with the concept of “sale or exchange” under the capital gains provisions of the Code.[[8]](#footnote-8) According to the IRS, if a contribution did not qualify as a “sale or exchange” for capital gain purposes, such as the proceeds from the grant of a nonexclusive license, the contribution cannot be a “transfer” of “property” “in exchange” under Section 351.

The Court of Claims analyzed whether Section 351 embodies the same notions as the capital gains provisions and found that the purpose of the capital gains provisions is to allow capital gain treatment when a person divests substantially all of its rights in property to a third person whereas the purpose of Section 351 is to ensure a transferor avoids immediate taxation when it rearranges its business assets and affairs by contributing certain assets to corporations:

However, we do view the contrasting purposes of the two parts of the Code as undermining, affirmatively and seriously, the Government's position. In order to qualify for the tax relief of lower rates under the capital gains provisions, there must be complete divestiture of the taxpayer's interest in property of a particular nature, capital assets. In such cases, there is no doubt about the actual flow of gain to the taxpayer from an outside source. Section 351, on the other hand, is not concerned with situations involving true severance of control and true flow of gain, but, rather, with instances which Congress considered as revealing illusory or artificial relinquishment of control and illusory or artificial gain. The transferor in section 351 cases is required to remain in control, albeit indirectly, after the transfer. There is, in short, a transfer in form only, a technical transfer not one of substance. The section is designed to give present tax relief for internal rearrangements of the taxpayer's own assets, accompanied by no sacrifice of control and no real generation of income for the owner and to defer taxation until a true outside disposition is made.

\* \* \* \* \*

This direct opposition in the aims of the two sets of provisions-the capital gains sections stressing the completeness of disposition by the taxpayer while section 351 is grounded in the taxpayer's continuance in control-supplies a compelling reason for putting aside, in applying the latter, capital gains formulations. *Id*. at 1214, 1216.

The Court of Claims in *Du Pont* found that “it would be odd to hold that a transfer had to look most like a complete disposition in order to avoid being treated for tax purposes as a complete disposition… .” Thus, the Court found the capital gains concept of a “sale and exchange” is simply irrelevant to Section 351, which has a different purpose. After finding the capital gains “sale or exchange” provision irrelevant, the Court of Federal Claims found the nonexclusive license as “property” for purposes of Section 351. After the *Du Pont* decision, the IRS issued a General Counsel Memorandum concurring with the holdings in *Du Pont* relating to the transfer of “property” for purposes of section 351.[[9]](#footnote-9)

1. *See for example,* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶ 3.01 (discussing the purpose of tax-free exchanges between corporations and shareholders). [↑](#footnote-ref-1)
2. *See E.I*[*.*](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) *DuPont* *de* *Nemours* [*&*](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) *Co*[*. v.*](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) *United*[*States,*471](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) [F.2d](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) 1211[,](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) 1218[,](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) 200 [Ct.Cl.](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) 391 [(](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) 1973[)](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePositionType=S&SerialNum=1973108206&ReferencePosition=1218) (“*Du Pont*”). [↑](#footnote-ref-2)
3. *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); *In the Matter of Chromeplate, Inc. (Chromeplate, Inc. v. District Director of Internal Revenue),* 614 F.2d 990, 995 (5th Cir. 1980). [↑](#footnote-ref-3)
4. [Rev. Rul. 69-](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=0001048&FindType=Y&SerialNum=1969013908)156, 1969[-1](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=0001048&FindType=Y&SerialNum=1969013908) [Cum.Bull.](http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=0001048&FindType=Y&SerialNum=1969013908) 101. [↑](#footnote-ref-4)
5. Maine and Nguyen, *Intellectual Property Taxation*, p. 295 (2003) (“*IP Taxation*”). [↑](#footnote-ref-5)
6. *See Du Pont, supra.*  [↑](#footnote-ref-6)
7. *Du Pont*, 471 F.2d at 1213. [↑](#footnote-ref-7)
8. *See* sections 1222 and 1001. [↑](#footnote-ref-8)
9. IRS GCM 36922. [↑](#footnote-ref-9)