DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR M. KENDALL WILLIAMS
ASSOCIATE AREA COUNSEL (LMSB) CC:LM:CTM:SJ
Attention: Caroline T. Chen
S. Katy Lin

FROM: Anne P. Shelburne
Assistant to the Branch Chief, Branch 6
Associate Chief Counsel (International)

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 6, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =
B =
C =
D =
‘AAA =

Components =
Corporation A =
Corporation B =
Court =
Customers =

Date 1 =
Date 2 =
Equipment =

Industry =

Marketer =

Patent 1 =
Patent 2 =
Patent 3 =
Patent 4 =
Patent 5 =
Patent 6 =
Process 1 =
Process 2 =

X Process =
X Process Action =
X System =
Y Process =
Y Process Actions =

ISSUES

1. What is the character of income from the $A lump sum cash payment Corp A received from Corp B pursuant to the settlement agreement executed to resolve the X Process Action and the Y Process Actions.

2. What is the source of income from the $A lump sum cash payment Corp A received from Corp B pursuant to the terms of the settlement agreement executed to resolve the X Process Action and the Y Process Actions.

3. Whether Corp A used a reasonable method of allocating the lump sum cash payment between U.S. source income and foreign source income by relying on third party information regarding Corp B's sales of Equipment enabled to run Corp A's X Process.

CONCLUSIONS

1. It is acceptable in this case to characterize the income from the $A lump sum cash payment Corp A received from Corp B pursuant to the settlement agreement executed to resolve the X Process Action and the Y Process Actions as royalty income.

2. The $A lump sum cash payment Corp A received from Corp B pursuant to the terms of the settlement agreement to resolve the X Process Action and the Y Process Actions constitutes income for the use of or privilege of using

property within the United States under Code section 861(a)(4) to the extent that the payment resolves claims of infringement of U.S.-registered patents. If Corp A can first, establish and support that a portion of the $A lump sum cash payment is attributable to infringement of its foreign counterpart Process 2 patents, and second, can establish a reasonable method to allocate amounts to the release of claims for the foreign counterpart Process 2 patents, such income may be treated as foreign source income under Code section 862(a)(4).

3. Corp A did not use a reasonable or appropriate method to allocate the $A lump sum cash payment between U.S. and foreign source income. Furthermore, Corp A's reliance on unverifiable third party information regarding Corp B's sales of Equipment enabled to run Corp A's X Process is an inappropriate basis upon which to allocate income between U.S. and foreign sources.

FACTS

The facts as we understand them are as follows.

Corporation A ("Corp A") is a U.S. corporation that develops, manufactures, markets and services Equipment and related parts for Industry. Corp A owns many U.S. and foreign counterpart patents related to the production process for Components. Corp A's Patent 1, a U.S.-registered patent, protects Process 1 for the production of such Components. U.S.-registered Patent 1 protects what is commonly referred to as "X Process." Process 1 is a process implemented by customers in the production of certain Components utilized by various industries. Corp A also owns U.S.-registered Patent 2, which relates to Process 2 for the production of Components.

Corporation B ("Corp B"), is a U.S. corporation that provides services and products to Industry similar to those services and products provided by Corp A. Corp B owns several U.S.-registered patents, including Patent 3, Patent 4, Patent 5 and Patent 6, which like Corp A's U.S.-registered Patent 2, relate to "Y Process."

X Process Action

On or about Date 1, Corp A filed a patent infringement action against Corp B in Court, a United States federal court, alleging that Corp B infringed Corp A's U.S.-registered Patent 1 ("X Process Action"). Corp A alleged that Corp B committed acts of infringement, acts of inducement of infringement, and contributory infringement under 35 U.S.C. §§ 271(a), (b), (c) and (g), as discussed further below, by manufacturing, testing, demonstrating, marketing and selling Equipment operated through software provided by Corp B, which were designed and enabled to run X Process, which infringed Corp A's U.S.-registered Patent 1. Corp B manufactured Equipment enabled with the infringing process in the United States, and demonstrated and sold Equipment to both U.S. and foreign Customers.

Y Process Actions

Corp A and Corp B subsequently filed additional patent infringement claims against each other alleging infringement of another patented process, Y Process ("Y Process Actions"). On or about Date 2, a date after Date 1, Corp A filed an action alleging that Corp B infringed Corp A's U.S.-registered Patent 2. Subsequently, Corp B filed an action alleging Corp A infringed Corp B's U.S.-registered Patent 3. Corp B also filed counterclaims against Corp A alleging Corp A infringed Corp B's U.S.-registered Patents 4, 5 and 6. The claims relating to U.S.-registered Patents 2, 3, 4, 5 and 6 are collectively referred to as the Y Process Actions.

As noted above, the X Process Action and the Y Process Actions were filed by Corp A and Corp B in Court, a United States federal court having jurisdiction over matters of federal law, including infringement of U.S. patents. Ultimately, a jury verdict was entered in favor of Corp A in the X Process Action regarding Corp B's alleged infringement of U.S.-registered Patent 1. Also, Court entered a decision for Corp B regarding Corp A's alleged infringement of U.S.-registered Patent 4 in the Y Process Actions. No damages were awarded in the jury verdict or court ruling. Corp A and Corp B subsequently executed a settlement agreement to settle and resolve the X Process Action and the Y Process Actions.

Corp A - Corp B Settlement Agreement Covering X Process and Y Process Actions

Relevant terms

With the intent of compromising their differences, and settling and resolving the X Process Action and the Y Process Actions, Corp A and Corp B entered into a settlement agreement that provided for two separate payment structures for the X Process Action and the Y Process Actions.

Pursuant to the terms of the settlement agreement, "X Process Action" refers only to the infringement claims brought in Court over U.S.-registered patent, Patent 1. The description of "X Process Action" does not include any reference to foreign counterpart patents. Corp A did not bring a claim against Corp B in the

Court proceedings for infringement of its foreign counterpart patents. Although "X Process Action" is not a term contained in the definition section of the settlement agreement, it is explained in the Recitals. Specifically, the first Recital to the settlement agreement provides,

> WHEREAS, on [Date 1], [Corp A] commenced an action for patent infringement against [Corp B] in [Court], Civil Action No. **** (the ["X Process Action]"), <u>in which [Corp A] asserted that [Corp B] was infringing [U.S.-registered Patent 1]</u>; and
>
> WHEREAS, after a jury trial, a jury verdict was entered in favor of [Corp A] and against [Corp B] in the [X Process Action] . . . . (Emphasis added).

Like "X Process Action," "Y Process Actions" is not a term contained in the definition section of the settlement agreement, but is explained in the Recitals to refer to specific U.S.-registered patents. "Y Process Actions" is described as the actions in which Corp A commenced a patent infringement action against Corp B for infringement of Corp A's U.S.-registered Patent 2, and the corresponding action in which Corp B alleged Corp A infringed Corp B's U.S.-registered Patents 3, 4, 5 and 6, respectively. The Recitals to the settlement agreement provide:

> WHEREAS, on [Date 2], [Corp A] commenced an action for patent infringement against [Corp B] in [Court], Civil Action No. ****, <u>in which [Corp A] asserted that [Corp B] was infringing [U.S.-registered Patent 2]</u>, and on [Date 2], [Corp B] commenced an action for patent infringement against [Corp A] in [Court], Civil Action No. ****, <u>in which [Corp B] asserted that [Corp A] was infringing [U.S.-registered Patent 6, Patent 5, Patent 3 and Patent 4]</u>, which two actions are referred to as the <u>["Y Process Actions"]</u>. (Emphasis added).

Finally, language in the settlement agreement releases any and all claims between Corp A and Corp B relating to the patent infringement litigation. Specifically, the Recital and Release sections of the settlement agreement further provide,

> WHEREAS, [Corp B] and [Corp A] desire to compromise their differences and settle and resolve the [X Process Action] and the [Y Process Actions]; . . . [Corp B] and [Corp A] agree as follows:
>
> Section 10. Releases

> b. [CORP A] . . . . hereby unconditionally releases and forever discharges [CORP B], each of its legal representatives, predecessors, successors . . . . from any and all claims, causes of action, demands, costs, obligations, damages, and liabilities of every kind, nature, and description whatsoever arising before the Effective Date, whether individual or derivative, state or federal, known or unknown, suspected or unsuspected, whether or not concealed or hidden, that arose under or relate to the [X Process Action], the [Y Process Actions], or any [CORP A] [PROCESS 2 PATENTS], including without limitation all claims in law or in equity that were asserted or could have been asserted by [CORP A] in connection with the [X Process Action] or the [Y Process Actions].

This paragraph is preceded by a similar paragraph in the settlement agreement regarding Corp B's release of Corp A from similar claims.

The term, "Process 2 Patents," used in Section 10, Releases, is a term defined in the definition section of the settlement agreement to mean Corp A Process 2 Patents and Corp B Process 2 Patents. The term appears to include both U.S-registered and foreign-registered patents. "Corp A Process 2 Patents" is a term defined in Section 1, Definitions, of the settlement agreement, in part, to mean,

> (1) [T]he issued patents owned by or assigned by [Corp A] as of the Effective Date which are set forth on Exhibit A hereto and any reissues, extensions, and reexamination certificates of such patents, (2) any patents resulting from the applications pending as of the Effective Date which are set forth on Exhibit B hereto and any reissues, extensions, and re-examination certificates of such patents, and (3) any patents resulting from any divisionals, continuations, or continuations-in-part . . . of the pending applications which are set forth on Exhibit B hereto and any reissues, extensions, and reexamination certificates of such patents.

Exhibit B, entitled "Patent Applications," lists Corp A's U.S.-registered and foreign-registered pending patent applications. "Corp B Process 2 Patents" is also a term defined in Section 1 of the settlement agreement, to mean, in part,

> (1) [A]ll issued patents owned by or assigned to [Corp B] as of the Effective Date, which patents are set forth on Exhibit C hereto and any reissues, extensions, and re-examination certificates of such patents, except United States patent numbers *** and ***, any foreign

> counterpart patents that issue or have issued from any application which led to or resulted in the [above 2 patents] . . . (2) any patents resulting from any or all applications pending as of the Effective Date, all of which pending applications are set forth on Exhibit D hereto . . . and (3) any patents resulting from any divisionals, continuations, or continuations-in-part . . . of the pending applications which are set forth on Exhibit D hereto . . . .

Exhibits C and D do not appear to be specifically identified as such, rather, there are several pages of Corp B patents attached to the back of the settlement agreement, following Exhibits A and B. It appears that these pages may be intended to be Exhibits C and D. One page lists Corp B's issued patents, the remaining pages list Corp B's pending patents. Both lists include Corp B's U.S-registered and foreign-registered patents.

Payment terms

The settlement agreement contemplated two types of payments for the infringement of U.S.-registered Patents 1, 2, 3, 4, 5, and 6. First, upon execution of the settlement agreement, Corp B agreed to pay Corp A a non-refundable $ A lump sum cash payment to settle and resolve the X Process Action and the Y Process Actions. Second, Corp B agreed to pay Corp A future royalties in exchange for a non-exclusive, worldwide, non-transferable and non-assignable license under the 'AAA patent license that would permit Corp B to exercise certain rights in the X System. Thus, the term " 'AAA" is used in the portion of the settlement agreement addressing the prospective royalty arrangement. In the definition section of the settlement agreement, the term " 'AAA" is defined as U.S.-registered Patent 1 and any foreign counterpart patents. The settlement agreement defines 'AAA as,

> [Patent 1], any foreign counterpart patents that issue or have issued from any application which led to or resulted in the ['AAA] patent, and patents that result or have resulted from any divisionals, continuations, or continuations-in-part from any application which led to or resulted in the ['AAA] patent or such foreign counterpart patents, and any reissues, extensions, and reexamination certificates of any of the foregoing patents.

The prospective royalties for the 'AAA license are determined as B% of the net revenue of any Industry manufacturing equipment wholly or partly configured or enabled to use X Process, or a fraction thereof, depending on whether all processing stations sold were configured or enabled to use X Process. "Net revenue" is defined in the settlement agreement to be the price invoiced by Corp B to Customers, with certain adjustments, upon a sale or other transfer of the X

System. Corp B could only sublicense the X System to Customers in limited circumstances to permit Customers to use the X System. The ‘AAA license was subject to and conditioned on Corp B’s timely payment of the $A lump sum cash payment. Additionally, Corp A and Corp B granted each other royalty-free, non-exclusive, worldwide, non-transferable and non-assignable cross-licenses for Corp A and Corp B Process 2 patents (which, as noted above, include not only U.S.-registered patents, but foreign counterpart patents, as well).

Corp A’s tax treatment of $A lump sum cash payment received from Corp B

During the taxable year at issue, Corp A received the $A lump sum payment from Corp B pursuant to the terms of the settlement agreement. Corp A filed its income tax return for the taxable year at issue, and deducted $C of estimated legal costs. Corp A characterized the net amount of the settlement payment, $D, as royalty income and apportioned it between U.S. source income and foreign source income based on Corp B’s ratio of total export sales of all products to Corp B’s total sales of all products, as reported in Corp B’s Securities and Exchange Commission 10-K filings. During audit of its taxable year at issue, Corp A informed the Audit Team that its foreign source income should be increased by roughly 5%, using the ratio of Corp B’s X System export sales over Corp B’s worldwide X System sales. The Corp B sales information on which Corp A relied in reapportioning its income between U.S. sources and foreign sources originated from several entities, including an independent market research company, Marketer, which purportedly gathers data from various entities, including media, institutional investors, and vendors.

The Audit Team is unable to independently verify Marketer’s sales data gathered on Corp B. The Audit Team and Corp A have agreed to characterize the $A lump sum cash payment as a royalty for purposes of sourcing the income. The Audit Team believes that the settlement payment received by Corp A should be sourced entirely as U.S. source income under Code section 861(a)(4).

LAW AND ANALYSIS

Issue 1 Character of $A lump sum cash settlement payment

The character of the $A lump sum cash payment turns on the nature of the underlying litigation. There is no direct legal authority characterizing a payment made pursuant to a settlement agreement executed to settle patent infringement litigation, where there is no direction from a court, jury or parties to the settlement as to how such payment is to be characterized.[1]

Federal courts have held that where a claim is resolved by a settlement agreement, the tax consequences of the settlement payment are controlled by the nature of the underlying action or litigation. United States v. Burke, 504 U.S. 229 (1992) (holding settlement payments are treated for tax purposes as if the payment was awarded in the underlying law suit); Tribune Publishing Co. v. United States, 836 F.2d 1176, 1177 (9th Cir. 1988). In characterizing settlement payments for tax purposes, courts have posed the question, "In lieu of what were the damages awarded?" Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944). See also Spangler v. Commissioner, 323 F.2d 913, 916 (9th Cir. 1963) (inquiring what taxpayer would have received if sums withheld wrongfully had been paid when due); Getty v. Commissioner, 913 F.2d 1486 (9th Cir. 1990) (stating that court must engage in the fiction of treating settlement proceeds as if they had been received by taxpayer in satisfaction of an alleged promise).[2] The language in complaints and settlement agreements may provide some evidence of the nature of the claim. Getty, 913 F.2d 1486 (9th Cir. 1990); Dower v. United States, 668 F.2d 264 (7th Cir. 1981); Rev. Rul. 83-177, 1983-2 C.B. 112 (where payments made to foreign partnership in satisfaction of contract for performance of services in foreign country would be income from sources without the United States, payments made in settlement of that obligation are considered payments made from sources without the United States).

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[1] In several instances, the Service has determined that settlement payments relating to patent infringement litigation are characterized as royalties. See Rev. Rul. 64-206, 1964-2 C.B. 591 (court awarded damages based on a reasonable royalty constitute amounts received for the right to use the patent, and were treated as royalties for purposes of applying the United States - Swiss income tax treaty); Rev. Rul. 80-15, 1980-1 C.B. 366 (payments pursuant to agreement to settle contractual suit for recovery of patent royalties were in lieu of amounts that would have been realized under patent agreement, and were treated as royalties under the United States - Italy income tax treaty). The circumstances of the present case are distinguished from these two revenue rulings, when in one case there was a court decision setting forth the basis for damages, and when in the other case there was an express trust agreement stating the trustee's authority to maintain a legal action for recovery of patent royalties.

[2] With regard to deductible expenses resulting from settlement payments, courts have also looked to the origin and character of the litigated claim, often determined by reference to court pleadings and the terms of settlement agreements. See generally Woodward v. Commissioner, 397 U.S. 572, 577-78 (1970); Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (7th Cir. 1970).

Tax treatment of settlement payments differs based on what the recovery represents. For example, payments representing reimbursement for lost profits or royalties are taxable income, whereas payments for injury to goodwill are returns to capital and generally are not taxable. Raytheon, 144 F.2d at 113; W.W. Sly Mfg. Co. v. Commissioner, 24 B.T.A. 65 (1931); Mathey v. Commissioner, 10 T.C. 1099 (1948), aff'd, 177 F.2d 259 (1st Cir. 1949), cert. denied, 339 U.S. 943 (1950).

Under federal law, relief for patent infringement includes injunctive relief, damages, and attorneys fees. 35 U.S.C. §§ 281-285. The Patent Act permits an award of damages for lost profits or a reasonable royalty.[3]

In this case, the $A lump sum cash payment to Corp A could be viewed as a payment in lieu of a reasonable royalty for Corp B's use of Corp A's patents. A payment for the transfer of intellectual property may be characterized as a royalty even if the payment is made in the form of a lump sum. Commissioner v. Wodehouse, 337 U.S. 369 (1949). The $A lump sum cash payment could also be viewed as a payment in lieu of profits Corp A might have received from the sale of Equipment enabled with the X Process had Corp B not infringed Corp A's patents.[4]

In the absence of a court opinion, or jury award in the present case, specifically characterizing damages awarded for patent infringement as lost profits or as a reasonable royalty, the settlement agreement, and some of the complaints and related documents filed by Corp A and Corp B in the litigation over U.S.-registered Patents 1, 2, 3, 4, 5, and 6 become relevant in characterizing the $A

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[3] Section 281 states:

> Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court.
>
> 35 U.S.C. § 281.

[4] For examples of court rulings on the issue of patent infringement and bifurcation of damages between lost profits and a reasonable royalty, see Polaroid Corp. v. Eastman Kodak Co., 641 F. Supp. 828 (D. Mass. 1985), stay denied, 833 F.2d 930 (Fed. Cir. 1986), aff'd, 789 F.2d 1556 (Fed. Cir. 1986), cert. denied, 479 U.S. 850 (1986); Polaroid Corp. v. Eastman Kodak Co., 16 U.S.P.Q. 2d 1481 (D. Mass. 1990), modified, Polaroid Corp. v. Eastman Kodak Co., 17 U.S.P.Q. 2d 1711 (D. Mass. 1991).

lump sum cash payment. Those documents indicate that either or both parties prayed for several types of remedies, including lost profits and reasonable royalties. The settlement agreement is silent as to whether the $A lump sum cash payment constitutes compensation for lost profits or for a reasonable royalty. In this instance, the characterization of the $A lump sum cash payment as a royalty is acceptable in the absence of guidance by Court as to whether the payment constitutes damages for lost profits or a reasonable royalty.

<u>Issue 2</u> <u>Source of Corp A's income from $A lump sum cash payment</u>

Since the source of income turns on the character of the $A lump sum cash payment as a royalty, the next issue is the source of the royalty paid to Corp A.

Code sections 861(a)(4) and 862(a)(4) govern the source of income from royalty payments for the use of intellectual property. Code section 861(a)(4) governs items of gross income, including patents, from sources within the United States, whereas section 862(a)(4) governs items of gross income from sources without the United States. Section 861(a)(4) provides,

> Rentals and royalties. Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.

I.R.C. § 861(a)(4). Code section 862(a)(4) employs the same terminology for items of gross income from sources without the United States. <u>See also</u> Treas. Reg. §§1.861-5.

Thus, in the present case royalty income from the use of or privilege of using patents within or without the United States is sourced pursuant to the royalty source rule of Code sections 861(a)(4) and 862(a)(4). To source the $A lump sum cash payment, it must be determined whether the U.S.-registered patents were used within or without the United States. The legislative history to the sourcing provisions of the Code is silent on the issue of where use of property occurs.

The Service has issued several revenue rulings that source royalty income to the place of use of intellectual property under Code sections 861(a)(4) and 862(a)(4). In Rev. Rul. 80-362, the Service concluded that royalties from a Netherlands corporation to another unrelated foreign corporation for the license of U.S. patent rights, with the royalty based on the number of units produced in the United States under the patent, were payments made for the use of the patent within the United States. Therefore, the royalties were treated as income from sources within the United States under Code section 861(a)(4). See also Rev. Rul. 84-78, 1984-1 C.B. 173 (income from use of foreign copyright to broadcast U.S. boxing match in foreign country constituted foreign source income under Code section 862(a)(4)); Rev. Rul. 74-555, 1974-2 C.B. 202 (payments received by a nonresident alien author for the license of American serial rights and rights to publish all new books in the United States were licenses for the use of or for the privilege of using copyrights in the United States).[5]

In addition to the revenue rulings, the Second Circuit in Sabatini v. Commissioner held that payments for the use of U.S. copyrights and U.S. contract rights were royalty payments for the use of property in the United States, and therefore constituted U.S. source income under Code section 119(a)(4), the predecessor to Code section 861(a)(4). Sabatini v. Commissioner, 98 F.2d 753 (2nd Cir. 1938). In Sabatini, the taxpayer had entered into a number of contracts with a U.S. publishing company, pursuant to which the taxpayer granted volume and second serial rights to publish in the United States books he had written. There were two kinds of books at issue, books for which U.S. copyrights could be obtained, and books for which no copyrights were obtainable, presumably because they were already in the public domain. Sabatini, 98 F.2d at 754-55. The court noted that the payments made to the taxpayer were in consideration for foregoing his right to authorize others to publish his works within the United States, and the payments therefore were U.S. source income. The court stated,

> [These works] were clearly in name and in fact royalties for the use of United States copyrights during their terms and renewals . . . . [T]he receipts by the author [for his copyrights] nevertheless fall within the statute as rentals or royalties for the use of or the privilege of using other like property. In this last named category fall also the payments received by the author from his contracts covering the publication of his uncopyrightable works. The payments were received in consideration of his granting the publisher the exclusive right to publish [in the United States] . . . . The payments were made to him for foregoing his right to authorize others for a time to publish the works [in the United States]. Though others may, perhaps, lawfully have published them they could not do so under his express authority. As in respect to the copyrightable works, he received royalties for granting the exclusive right to publish with his express permission. The rights he granted were an interest in property in the United States, in the one instance the statutory copyrights obtainable and in the other the exclusive right to publish with his permission.

[5] See also Rev. Rul. 72-232, 1972-1 C.B. 276; Rev. Rul. 68-443, 1968-2 C.B. 304.

Sabatini v. Commissioner, 98 F.2d 753, 755 (2nd Cir. 1938), aff'g in part 32 B.T.A. 705 (1935). Thus, the court sourced to the United States the income from the U.S. copyrights and the U.S. contract rights on the basis that the royalties were paid for property located in and used in the United States.

Consistent with the principles of the revenue rulings and the Second Circuit's opinion in Sabatini, the $A lump sum cash payment is properly treated as U.S. source income from the use of U.S. patents within the United States. In the present case, the settlement agreement, based on our interpretation, settles claims of infringement of U.S.-registered patents[6], subject to legal protection only in the United States, and the underlying claims litigated in Court concerned only U.S.-registered patents.

Significantly, the language of the settlement agreement states that it settles and resolves the X Process Action and the Y Process Actions. Those actions involved claims by Corp A and Corp B of direct infringement, inducement to infringe, and contributory infringement of U.S.-registered patents pursuant to sections 271(a), (b), (c) and (g) of the Patent Act. Section 271 of the Patent Act provides, in part,

> Section 271. Infringement of patent
>
> (a) Except as otherwise provided in this title, whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefor, infringes the patent.
> (b) Whoever actively induces infringement of a patent shall be liable as an infringer.
> (c) Whoever offers to sell or sells within the United States or imports into the United States a component of a patented machine, manufacture, combination or composition, or a material or apparatus for use in practicing a patented process, constituting a material part of the invention, knowing the same to be especially made or especially adapted for use in an infringement of such patent, and not a staple

[6] The language of the settlement agreement, specifically Section 10, Releases, fails to state whether a portion of the $A lump sum cash payment constitutes compensation for infringement of the foreign counterpart Process 2 patents or whether the $A lump sum cash payment is independent and exclusive of each party's promise to refrain from exercising legal rights with regard to alleged infringement of foreign counterpart Process 2 patents.

> article or commodity of commerce suitable for substantial noninfringing use, shall be liable as a contributory infringer . . . .
>
> (g) Whoever without authority imports into the United States or offers to sell, sells, or uses within the United States a product which is made by a process patented in the United States shall be liable as an infringer, if the importation, offer to sell, sale, or use of the product occurs during the term of such process patent . . . .

35 U.S.C. §§ 271 (a)-(c), (g) (emphasis added).

Under the statutory language above, the only acts relevant to infringing a U.S. process patent are those that occur within the United States.[7] Furthermore, federal courts have noted that U.S. process patents have effect only in the United States. See generally Cybiotronics, Ltd. v. Golden Source Electronics, Ltd., 2001 U.S. Dist. LEXIS 2094 (C.D. Cal. 2001) quoting Pfizer Inc. v. Aceto Corp., 853 F. Supp. 104, 105 (S.D.N.Y. 1994); accord Tec Air, Inc. v. Nippondenso Mfg. U.S.A., Inc., 1997 U.S. Dist. LEXIS 1081 (N.D. Ill. 1997).

Thus, income from the $A lump sum cash payment is from property located in and used in the United States within the meaning of Code section 861(a)(4), and thus is from U.S. sources. If Corp A is able to establish and support from the settlement agreement that a portion of the $A lump sum cash payment is attributable to foreign counterpart Process 2 patents and subsequently provides a reasonable allocation method, some of the $A lump sum cash payment may appropriately be treated as foreign source income.

Issue 3 Corp A's Allocation Method

In the present case, Corp A failed to provide a reasonable allocation

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[7] The legislative history to the Process Patents Amendments Act of 1988 states that U.S.-registered process patents are legally protected from acts of infringement occurring within the United States. The Senate Report provides,

> Section 271(g) was not intended, and indeed there is serious doubt whether Congress . . . [could] prevent the use of a U.S. patented process in another country. Thus, [section] 271(g) 'will not give extraterritorial effect to U.S. law' and provides no remedy against foreign manufacturers whose infringing acts do not occur within the United States.

S. Rep. No. 83, 100th Cong., 1st Sess. 48, quoted in Cybiotronics, 2001 U.S. Dist. LEXIS 2094, 75-77.

method to support its assertion that any of the $A lump sum cash payment was derived from sources without the United States under Code section 862(a)(4).

Corp A has proposed to allocate the entire $A lump sum cash payment between U.S. and foreign sources based on the ratio of Corp B's X System export sales over Corp B's worldwide X System sales. This is an inappropriate basis to allocate income from the $A lump sum payment between U.S. and foreign sources since, as described above, the settlement agreement resolves infringement claims for U.S.-registered patents only, with the possible exception of the foreign counterpart Process 2 patents. Furthermore, it is inappropriate for Corp A to rely on data not subject to verification by the Audit Team in determining the source of the $A lump sum cash payment.

In addition, Corp A has not yet established and supported based on the settlement agreement that some portion of the $A lump sum cash payment is attributable to foreign counterpart Process 2 patents, and has not provided any basis for allocating some portion of the $A lump sum cash payment if any, that may be attributable to the foreign counterpart Process 2 patents.

Several courts have considered the issue of what constitutes a reasonable allocation of income between U.S. and foreign sources. Courts have held that parties to agreements are best able to properly allocate income, and when there is no allocation made or no basis for the allocation made, the full amount of income is deemed to be from sources within the United States. See generally Molnar v. Commissioner, 4 T.C.M (CCH) 951 (1945), aff'd by 156 F.2d 924 (2nd Cir. 1946); accord Estate of Alexander Marton v. Commissioner, 47 B.T.A. 184 (1942). In Rohmer v. Commissioner, 5 T.C. 183 (1945), aff'd by 153 F.2d 61 (2nd Cir. 1946), cert. denied, 328 U.S. 862 (1946), the Second Circuit held the Tax Court was not unreasonable in stating that the full amount of royalties for a license of U.S. and Canadian serial rights in a manuscript were deemed to be from sources within the United States when the parties did not attempt to segregate the value of U.S. and Canadian rights. In addition, figures for U.S. and Canadian circulation of a magazine in which the manuscript was published did not constitute a sufficient basis to determine that any of the income was from sources without the United States. Accord Misbourne Pictures Ltd. v. Johnson, 90 F. Supp. 978 (S.D.N.Y. 1950), aff'd by 189 F.2d 774 (2nd Cir. 1951) (holding the entire payment for the license of an exclusive right to distribute a film in the United States and in foreign countries was income from sources within the United States, where the taxpayer provided no basis for apportionment of a payment between U.S. and foreign sources). The cases discussed further below indicate that courts have imposed strict standards and generally have required a strong nexus between a taxpayer's allocation of income to U.S. and foreign sources and the taxpayer's basis or method for allocating the income.

Estate of Marton v. Commissioner involved the sale of Petitioner's decedent's worldwide motion picture rights in a novel to Metro-Goldwyn-Meyer ("MGM"). The parties to the agreement did not allocate the amounts paid between U.S. and foreign rights. Petitioner argued that only a portion of the consideration was income from within the United States for the transfer of U.S. rights where the rights conveyed to MGM were worldwide rights. Petitioner claimed that a reasonable allocation could be made between U.S. source income and foreign source income based on the percentage of MGM's total income from U.S. and foreign sources during the four-year period following its acquisition of the motion picture rights, although MGM had never used the rights acquired. In holding that the royalty received from MGM for the transfer of motion picture rights was from sources within the United States, the Marton court stated, in part,

> We think that the segregation of the purchase price upon the basis of income derived by the corporation from its production and exhibition of other pictures in this and foreign countries would be wholly unjustified. It would have been a simple matter for the parties to have segregated the purchase price of the domestic from the foreign rights. This they did not do and we can not supply that omission by surmise. For all we know, the foreign rights to this picture were considered of little or no value . . . . [T]he total consideration paid to the decedent is, we think, subject to income tax as income from sources within the United States. The question is similar to that presented in Sabatini v. Commissioner [citation omitted], where it was held that the amount paid for the exclusive world-wide rights to produce motion pictures based upon the works of that author must be deemed to be from sources within the United States, since it was paid for the use of those rights in the United States and the contested royalty emanated from that source.

Estate of Marton v. Commissioner, 47 B.T.A. 184, 186-187 (1942).

Applying a similar analysis as in Marton, the Second Circuit in Molnar v. Commissioner, rejected evidence of receipts from other motion pictures not involving the taxpayer's copyright, as a basis for allocating the taxpayer's royalty income between U.S. and foreign sources. Molnar v. Commissioner, 4 T.C.M (CCH) 951 (1945), aff'd by 156 F.2d 924 (2nd Cir. 1946). In Molnar, the taxpayer licensed worldwide motion picture rights in a play to R.K.O. Radio Pictures, Inc. ("R.K.O."). R.K.O. never produced a motion picture based on the rights the taxpayer granted in the play. The taxpayer also licensed motion picture rights in a short story to a domestic motion picture producer who permitted Twentieth Century Fox-Film Corporation ("Twentieth Century Fox") to distribute a film that included the taxpayer's short story as a part of a motion picture distributed by Twentieth Century Fox in the United States and abroad.

In sourcing his taxable income from the play and short story rights licensed to R.K.O. and Twentieth Century Fox, the taxpayer relied on all motion picture receipts of R.K.O. to source income from the license of the play, and receipts of Twentieth Century Fox from the distribution of the film incorporating the short story to source income from the license of the short story. In both instances, the court rejected the taxpayer's reliance on R.K.O.'s and Twentieth Century Fox's motion picture receipts as a basis to apportion the royalties between U.S. and foreign sources. The Second Circuit affirmed the Tax Court's holding supporting the Commissioner's determination that all income received by the taxpayer for the license of copyrights was from sources within the United States. The Molnar court cited Marton favorably for the proposition that proof based on production and exhibition of pictures other than the one in question was not an appropriate basis for sourcing the taxpayer's income. Molnar, 156. F.2d at 925-26 quoting Estate of Marton, 47 B.T.A. 184, 186 (1942).

In the present case, if Corp A wants to allocate income, if any, to some portion of the $A lump sum cash payment attributable to the Process 2 patents between U.S. and foreign sources, it must establish a reasonable basis for such allocation consistent with the courts' requirements that a strong nexus exist between the allocation method and the income to be allocated. In addition, the principles of the cases described above demonstrate that Corp A's reliance on Corp B's sales of Equipment enabled to run Corp A's infringed X Process is not a sufficient basis to allocate the entire $A lump sum cash settlement payment between U.S. and foreign source income, since Corp B's receipts from sales to U.S. and foreign customers of Equipment enabled with the X Process (Equipment of foreign customers that subsequently employed the process outside the United States) are not closely related to the settlement of both X Process and Y Process Actions, actions which release U.S. patent infringement claims. Also, it is inappropriate for Corp A to rely on information not verifiable by the Audit Team as the basis for the allocation between U.S. source income and foreign source income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 874-1490 if you have any further questions.

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