Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.1441-1: Requirement for deduction and withholding of tax on payments to foreign persons.
(Also: Part I, §§ 263, 263A)

Rev. Proc. 2007-23

SECTION 1. PURPOSE

This revenue procedure provides administrable tax rules under domestic and international provisions of the Internal Revenue Code for certain patent cross licensing arrangements. This revenue procedure is issued in response to comments and requests for guidance in connection with Notice 2006-34, 2006-14 I.R.B. 705. In general, and as described below, this revenue procedure provides rules permitting taxpayers to change to, or continue to use, the Net Consideration Method described in section 5 of this revenue procedure for a qualified patent cross licensing arrangement (QPCLA) described in section 4 of this revenue procedure. This revenue procedure does not provide rules concerning the treatment of cross licensing arrangements that

are not QPCLAs.

SECTION 2. DEFINITIONS

.01 *Application*. The definitions contained in this section 2 apply only for purposes of this revenue procedure.

.02 *Cross Licensing Arrangement.* A “cross licensing arrangement” is a contractual arrangement between two or more parties that own intellectual property under which each party grants to the other a license of specified intellectual property that is properly characterized as a license under applicable U.S. tax law principles.

.03 *Consideration.* The term “consideration” means, with respect to a cross licensing arrangement, any license rights, cash, or other consideration paid or received pursuant to the arrangement.

.04 *Controlled.* The term “controlled” has the same meaning as in § 1.482-1(i)(4) of the Income Tax Regulations.

SECTION 3 . BACKGROUND

.01 *Request for Comments*. Notice 2006-34 requested comments, information, and documents on cross licensing arrangements, including the: (i) business circumstances in which the arrangements arise; (ii) legal and factual means for distinguishing between different types of, or uses for, the arrangements; (iii) means for sourcing income from the arrangements; (iv) means for valuing cross-licensed rights; (v) financial accounting treatment of the arrangements; and (vi) foreign tax treatment of the arrangements.

.02 *Comments.* In response to the requests for information contained in Notice

2006-34, several commentators stated that many cross licensing arrangements are entered into primarily to provide each party with unfettered use of its own patents. In this way, the parties seek "freedom to operate" or the freedom to use their own intellectual property without threat of costly patent litigation from the potentially competing patent claims of the other party. These arrangements may be worded to insure "patent exhaustion" (that is, they are worded to confer rights to make, have made, import, sell, lease, use, or otherwise dispose of patented products). Commentators also stated that the use of cross licensing arrangements in this context would not typically include the transfer of other technology, such as know-how, copyright, or trademark rights. Commentators also indicated that these arrangements may or may not involve cash payments. These arrangements generally are nonexclusive.

Commentators indicated that parties to a cross licensing arrangement entered into to avoid patent litigation typically do not attempt to value the underlying patents prior to entering into the arrangement beyond a broad relative judgment that is reflected in the amount of cash payments, if any, between the parties.

Commentators pointed to the particular circumstances of patent law. Reports offered by the U.S. Patent and Trademark Office (USPTO) indicate drastic increases in the numbers of patents applied for and granted over the last 50 years. For instance, in 1950 the USPTO received 74,108 patent applications and granted 47,847 patents; by 2000, the USPTO received 315,015 patent applications and granted 175,455 patents. United States Patent and Trademark Office, *Table of Annual U.S. Patent Activity Since*

1790, *available at* http://www.uspto.gov/web/offices/ac/ido/oeip/taf/h_counts.pdf. At the same time, commentators indicated that a large number of patent infringement suits are filed each year with large associated costs. Commentators indicated that businesses, when faced with a potential "patent thicket," often choose to negotiate and enter into cross licensing arrangements rather than face uncertain results and expenses that might accompany patent litigation.

Commentators also described other technology sharing business arrangements that may involve a shared business purpose and the sharing of intellectual property beyond patent rights. In addition to providing information regarding the different uses for cross licensing and other technology sharing arrangements, commentators stated their view that, under established tax law principles, the execution of a cross licensing arrangement without any cash payment is not an income recognition event that would trigger withholding tax.

Commentators also indicated that attempting to value any rights granted under a cross licensing arrangement, or to source any income arising therefrom, would be extremely difficult, likely incorporating all of the uncertainties of both patent law and tax law. Commentators indicated that, under U.S. generally accepted accounting principles, profit or loss is generally reported with respect to cross licenses and similar arrangements only to the extent of any cash payments. Commentators said that several policy objectives, including maintaining U.S. competitiveness in the global marketplace in light of foreign taxation rules, would be hindered if an amount in excess of any cash received under a cross licensing arrangement were subject to withholding.

For all these reasons, commentators urged that only cash received under a cross licensing arrangement should be subject to withholding.

.03 *Applicable Law*.

Section 61(a) of the Internal Revenue Code provides the general rule that, except as otherwise provided by law, gross income includes all income from whatever source derived.

Section 162 permits a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Section 263A provides that in the case of any property to which § 263A applies, the direct costs of such property and such property's proper share of those indirect costs (including taxes), part or all of which are allocable to such property shall, in the case of property which is inventory in the hands of the taxpayer, be included in inventory costs and, in the case of any other property, shall be capitalized. With certain exceptions, § 263A applies to real or tangible personal property produced by the taxpayer and real or personal property described in § 1221(a)(1) which is acquired by the taxpayer for resale.

In relevant part, §§ 871(a) and 881(a) impose a 30-percent tax on U.S. source fixed or determinable annual or periodical gains, profits, and income (FDAP) received by nonresident aliens and foreign corporations to the extent such FDAP is not effectively

connected with the conduct of a trade or business within the United States. Royalties, whether paid in one lump sum or periodically, constitute FDAP. Commissioner v. Wodehouse, 337 U.S. 369, 392 (1949); see also §§ 1.871-7(b)(1) and 1.1441-2(b).

Section 1441(a) provides the general rule that all payors having the control, receipt, custody, disposal or payment of items described in § 1441(b) must deduct and withhold a tax equal to 30 percent on payments of certain items of income to nonresident aliens to the extent that such items constitute gross income from sources within the United States. Section 1441(b) provides that these items of income include interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations and emoluments or other fixed or determinable annual or periodical gains, profits, and income. Section 1442(a) provides that, in the case of foreign corporations subject to taxation under subtitle A of the Code, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in § 1441 a tax equal to 30 percent thereof.

Section 861(a)(4) provides that 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, shall be treated as income from sources within the United States.

Section 862(a)(4) provides that rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights,

secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property, shall be treated as income from sources without the United States.

Section 863(a) provides that items of gross income, expenses, losses, and deductions, other than those specified in §§ 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary.

Section 863(b) provides that, in the case of gross income derived from sources partly within and partly without the Unites States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The section further provides that the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary.

Sections 871(b) and 882 provide that when a nonresident alien individual or a foreign corporation is engaged in a trade or business within the United States, the individual or corporation is taxable at U.S. graduated tax rates on taxable income which is effectively connected with the conduct of a trade or business within the United States (ECI). Section 864(c) provides specific rules for determining the income, gain, or loss treated as ECI.

Section 1031(a)(1) provides generally that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if

such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. For § 1031 to apply, a taxpayer must have realized gain or loss from a disposition of property, as described in § 1001. While a sale or other disposition of a patent generally gives rise to a gain or loss under § 1001, the mere grant of a patent license does not because it is not a sale or other disposition of property within the meaning of § 1001(a). Similarly, gain or loss under § 1001 does not arise in the case of mutual grants of licenses. Thus, § 1031 has no application to a QPCLA addressed in this revenue procedure.

In general, the foregoing rules regarding inclusion, deduction, sourcing, and withholding operate independently as to each item of gross income and expense.

.04 *Administrability Issues*. The Treasury Department (Treasury) and the Internal Revenue Service (IRS) recognize that QPCLAs entered into by uncontrolled parties to pursue their businesses free from potential patent infringement claims raise many difficult issues for both taxpayers and the IRS. In light of the large number of patent applications and grants, and the difficulty and cost of resolving patent infringement disputes, it is often very difficult to ascertain the validity and scope of patent rights without incurring significant expense, which may include the cost of litigation. Thus, this unique interaction of patent and tax law creates administrative challenges for the taxation of QPCLAs.

For instance, while valuation of intellectual property is always difficult, valuation of patent rights is exceedingly difficult where the parties enter into the cross licensing arrangement to avoid or settle patent infringement disputes. Uncertainty in the patent

law increases the difficulties of reaching a valuation when the parties enter into a cross licensing arrangement to avoid the costs and risks of determining their ultimate patent rights by litigation.

Similarly, the sourcing of gross income from QPCLAs entered into to avoid or settle patent infringement disputes may present administrative problems. In those arrangements, the difficulty in tracing the location and use of intangibles to a particular jurisdiction in the absence of objective benchmarks (for example, if a QPCLA did not provide for per-unit cash royalties based on sales of products) may make it difficult to allocate income to a particular source.

For these reasons, Treasury and the IRS have determined that, in the interest of sound tax administration, taxpayers are not required to take into account amounts other than the "net consideration" as defined in section 5.02 of this revenue procedure for QPCLAs described in section 4 of this revenue procedure.

SECTION 4. QUALIFIED PATENT CROSS LICENSING ARRANGEMENT (QPCLA)

A QPCLA is a nonexclusive, nontransferable patent cross licensing arrangement among uncontrolled parties, the subject matter of which is limited to the parties' present or future patent rights, as specified in the arrangement. If the parties to an arrangement also engage in more than de minimis licensing or other transfer of other intangible property (including copyrights, trademarks, and know how) pursuant to the arrangement, the arrangement is not a QPCLA. The determination of whether the licensing or other transfer of other intangible property is de minimis is determined under all the facts and circumstances.

SECTION 5. NET CONSIDERATION METHOD

.01 *Scope*. The Net Consideration Method provided in this section 5 may be used for a QPCLA by any taxpayer without regard to whether the taxpayer has made a payment of income subject to withholding with respect to the QPCLA.

.02 *Net Consideration.* For purposes of this section, "net consideration" is defined as the amount of consideration other than license rights and de minimis other intangible property received in the taxable year by a party pursuant to the arrangement, reduced by the amount of consideration other than license rights and de minimis other intangible property paid in the taxable year by the party pursuant to the arrangement.

.03 *Financial Statement Conformity.* A taxpayer may not use the Net Consideration Method discussed in this section for a QPCLA unless the taxpayer takes into account only the "net consideration", as defined in subsection 5.02 of this revenue procedure, for such arrangement on its audited financial statements (if any), or similar statement in the case of a foreign corporation, for all years ending after February 14, 2007, that the net consideration method is used for tax purposes.

.04 *Use of Net Consideration Method.* A taxpayer choosing to use the Net Consideration Method must apply the Net Consideration Method as provided in sections 5.05 and 5.06 of this revenue procedure. The use of the Net Consideration Method will be presumed to clearly reflect a taxpayer's income.

.05 *Withholding.* Under the Net Consideration Method, only the net consideration transferred between the parties to a QPCLA during a taxable year will be taken into account for withholding purposes. The Net Consideration Method applies

whether the QPCLA is entered into in advance of, during, or after a patent dispute.

.06 *Capitalization.* Under the Net Consideration Method, only the net consideration transferred between the parties to a QPCLA during a taxable year will be taken into account for capitalization purposes under § 263(a) or § 263A of the Code .

.07 *Example.* X, a domestic corporation, and Y, a foreign corporation, each hold patents potentially implicated by the manufacture and sale of product P. In addition, each actively engages in the manufacture and sale of product P on a global basis. Y does not have income effectively connected with a U.S. trade or business. In 2007, X and Y enter into a QPCLA with respect to their respective patents. In accordance with the terms of the QPCLA, $20 million is paid by X to Y. The only consideration for the QPCLA taken into account on X's financial statements is the $20 million payment made by X to Y. X may use the Net Consideration Method to determine its withholding obligations and the amount subject to capitalization for federal income tax purposes.

Under the Net Consideration Method, only the $20 million payment made by X under the QPCLA is treated as income to Y for withholding purposes. Therefore, withholding under § 1442 will apply only with respect to the portion of the $20 million payment by X attributable to U.S. sources under § 861(a)(4). Further, only the $20 million payment by X is subject to capitalization under § 263(a) or § 263A.

SECTION 6. CHANGE IN ACCOUNTING METHOD

A change in the reporting of a QPCLA to the Net Consideration Method described in section 5 of this revenue procedure is a change in method of accounting within the meaning of §§ 446 and 481 and the regulations issued thereunder.

Accordingly, a taxpayer that wishes to change its treatment for a QPCLA to the Net Consideration Method must obtain the consent of the Commissioner under §§ 446(e) and 1.446-1(e)(3).

SECTION 7. EFFECTIVE DATE

In general, the rules described in this revenue procedure apply to a QPCLA entered into on or after February 14, 2007.

SECTION 8. QPCLAS ENTERED INTO PRIOR TO THIS REVENUE PROCEDURE.

Use of the Net Consideration Method described in section 5 of this revenue procedure for a QPCLA entered into prior to February 14, 2007 will not be raised as an issue by the IRS. If a taxpayer uses the Net Consideration Method described in section 5 of this revenue procedure for one or more QPCLAs entered into prior to February 14, 2007, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9 or its successor) in examination, in appeals, or before the U.S. Tax Court, that issue will not be further pursued by the IRS.

SECTION 9. COMMENTS

.01 *Comments Requested.* The Treasury and IRS request comments on the definition of a QPCLA and whether the Net Consideration Method also should extend to other types of cross licensing arrangements and, if so, under what conditions.

For example, comments are requested on the tax treatment of cross licensing arrangements for the joint development of intellectual property discussed in comments in response to Notice 2006-34. Such cross licensing arrangements are not within the definition of a QPCLA because the parties to such arrangements also engage in more

than de minimis licensing or other transfer of other intangible property pursuant to the arrangements. The Treasury and IRS are considering, however, whether it may be appropriate to extend similar tax treatment to those arrangements. See §1.482-7(g)(2) and (g)(8), Examples 4 and 5.

.02 *Submission of Comments.* Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: John E. Hinding (Revenue procedure 2007-23), CC:INTL:6, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to revenue procedure.comments@irscounsel.treas.gov. Please include "Revenue Procedure 2007-23" in the subject line of any electronic communications. Comments will be available for public inspection and copying.

SECTION 10. DRAFTING INFORMATION

The principal authors of this revenue procedure are John E. Hinding of the Office of Associate Chief Counsel (International) and Martin Scully, Jr. of the Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury participated in their development. For comments or questions regarding the international provisions applicable to cross licenses covered by this revenue procedure, contact John E. Hinding at 202-435-5265 (not a toll free call). For comments or questions regarding the domestic provisions applicable to cross licenses covered by this revenue procedure, contact Martin Scully, Jr. at 202-622-8066 (not a toll free call).