I.R.S. ARGUES MYLAN'S CONTRACT IS A LICENSE OF DRUG RIGHTS – NOT A SALE

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The question of the proper treatment of a contract transferring exclusive rights to the use of a patent – as a sale or a license – is one that has been addressed many times in U.S. jurisprudence. It has recently popped up again in a case before the U.S. Tax Court involving the generic pharmaceutical company Mylan Inc. ("Mylan"),[1] a company that is the subject of much negative publicity arising from its inversion and subsequent re-immersion as a U.S. domestic company.

In September, the I.R.S. filed a memorandum in support of a motion for summary judgment. The memorandum explained why the Tax Court should rule that a 2008 amendment to a license between Mylan and Forest Laboratories Holdings Limited ("Forest") is merely an amended license agreement and not a relinquishment of all of rights to the use of drug. As a mere amendment to a license that continues to exist, Mylan should report ordinary income. As an amendment that relinquished all remaining substantial rights for the licensor, capital gain treatment is appropriate. In its tax return, Mylan reported the 2008 amendment as a sale giving rise to capital gain treatment. This allowed the corporation to utilize a capital loss carryback as a means of reducing taxable income from the transaction. A capital loss carryback cannot reduce ordinary income.

BACKGROUND

Mylan is a generic pharmaceutical company that entered into a license contract in 2001 with Janssen Pharmaceutica N.V. ("Janssen"), a Belgian pharmaceutical corporation that developed and holds patents to the anti-hypertensive compound nebivolol. The Janssen contract granted Mylan an exclusive license to import, make, use, and sell nebivolol and nebivolol products within the U.S. and Canada.

In January 2006, Mylan sublicensed its rights in nebivolol to Forest, an Irish company that develops, manufactures, and markets pharmaceutical products. The two drug companies entered into the 2006 contract in which Forest paid Mylan $75 million and agreed to royalty payments in exchange for the right to develop and commercialize nebivolol in the U.S. and Canada. The 2006 contract gave Forest all responsibility in commercializing nebivolol but provided that Mylan could participate in aspects of the commercialization. The 2006 contract referred to the agreement between Mylan and Forest as a license agreement, and Mylan treated it as such, characterizing payments received from Forest during 2006 and 2007 as ordinary income.

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[1] *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *memorandum*, Sept. 16, 2015.

In 2008, the two companies executed an amendment to the 2006 contract in which Mylan assigned to Forest all rights to participate in the commercialization of nebivolol. In return for the assignment, Mylan received a one-time cash payment of $370 million and about $50 million in additional royalty payments. However, the world is not perfect, and Mylan retained certain rights and obligations in relation to the product and the supplier. These included

- the right and obligation to acquire all commercial supplies of nebivolol from Janssen and make all payments due to Janssen;
- the right to be the exclusive supplier of nebivolol to Forest combined with the obligation to purchase its supply from Janssen;
- the right to receive information and documents regarding Forest's contacts with regulatory authorities, to participate in Forest's meetings with regulatory authorities, and to provide input towards Forest's marketing plans, strategies, and pricing;
- the right to use nebivolol;
- the right to its knowhow;
- the right to prevent Forest from discounting nebivolol in order to promote sales of its other products;
- the right of first offer calling for Forest to negotiate with Mylan for the distribution of authorized generic nebivolol medication before seeking to arrange for distribution of authorized generics with a third party; and
- a co-exclusive right with Forest to develop and commercialize nebivolol for the treatment of migraine headaches.

"In its examination of the year 2008, the I.R.S. viewed the 2008 contract as a license, not a sale...[and] issued a notice of deficiency, asserting deficiencies in Mylan's 2007, 2008, and 2011."

Forest could neither assign nor sublicense its rights to third parties without Mylan's prior written consent.

In its tax return for 2008, Mylan characterized the 2008 transfer of rights in the nebivolol patent to Forest as an installment sale and reported the payments it received from Forest as capital gains. Mylan received payments in 2009 and 2010 under the 2008 amendment, which Mylan treated as installment payments under the 2008 transaction. These payments were also reported as capital gains. The support for this reporting position was that the transactions "transferred all substantial rights Mylan had in nebivolol, and binding precedent requires that the transfer of all substantial rights be treated as a sale."[2] The purported motivation for the transaction was Mylan's inadequate marketing capabilities and the need to improve its capital structure.

In its examination of the year 2008, the I.R.S. viewed the 2008 contract as a license, not a sale. The I.R.S. issued a notice of deficiency, asserting deficiencies in Mylan's 2007, 2008, and 2011 income taxes in the following amounts:

- 2007 – $1,223

[2] *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *petition*, Jul. 11, 2014.

- 2008 – $98,622,234
- 2009 – $1,215,101 (Attach. A11)

Mylan petitioned the Tax Court for a redetermination of amounts due, asserting that the I.R.S. incorrectly characterized the 2008 transfer as a license because Mylan had relinquished all substantial rights to nebivolol.[3]

Subsequently, the I.R.S. issued an additional notice of deficiency in the amount of $4,382,422 for 2009. Mylan filed a second petition to the Tax Court, this time seeking a redetermination for 2009.[4] Mylan's petitions have been consolidated into a single Tax Court proceeding asserting that the I.R.S.'s deficiency assessments are erroneous because they result from the I.R.S.'s "incorrect determination that Mylan's 2008 sale of nebivolol to Forest was not a sale of a capital asset but rather payments made by Forest in exchange for the use of intellectual property."[5] In sum,[6] Mylan's overall position is that the controversy is a "sale versus license dispute" and the I.R.S.'s position that the 2008 transfer of rights was a license generating ordinary income is "meritless" because almost all of Mylan's rights were relinquished.[7]

When the initial pleadings were completed, the I.R.S. moved for summary judgment in its favor, contending that no genuine issue of material fact exists and that a decision in its favor should be given by the Tax Court as a matter of law distinguishing between a sale and a license.

SALE V. LICENSE TREATMENT

Generally, a sale occurs for tax purposes when all substantial rights to the property have been relinquished, whereas a license occurs when the person transferring the rights retains a power or significant interest. If a transaction is characterized as a sale and the asset being sold is a capital asset, the net gain after offset for the unrecovered cost basis is taxed as a capital gain. If a transaction is characterized as a license, the gross license payments are taxed as ordinary income without any offset.

For corporate taxpayers, capital gains and ordinary income are taxed at the same rate. However, the characterization of a transaction as capital gains or ordinary income can be important if the corporation has capital losses that would be limited without the recognition of capital gains. Under Code §1211,[8] a corporation's net capital losses in any tax year may be claimed as a deduction only to the extent of

3 *Id.*

4 *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *petition*, Nov. 13, 2014.

5 *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *petition*, Jul. 11, 2014.

6 Mylan further asserted that the I.R.S. erred by not allowing Mylan to recover its basis in the property and in not allowing Mylan to compute gain under income forecast method. These are secondary arguments to ensure that full relief is obtained if the Tax Court agrees with Mylan's basic position.

7 *Id.*

8 All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

the capital gains of that year. Unused net capital losses for any year can be carried back three years and forward five years.[9] Mylan had capital losses that could be carried over to one or more of the relevant years.

Note that special rules apply when determining if the transfer of use of a patent is properly treated as a sale by an individual that is a "holder" of a patent. This provision is intended to encourage amateur inventors by providing long-term capital gains treatment for transfers of all substantial interests in the patent. A patent "holder" is any individual whose efforts created the patent or any other individual who has acquired such interest in the patent in exchange for consideration in money or money's worth paid to the creator prior to the actual reduction to practice of the invention covered by the patent. Mylan would not be a "holder."

The Code does not define "all substantial rights," but legislative history suggests that "exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be 'sales or exchanges' because, in substantive effect, all 'right, title, and interest' in the patent property is transferred."[10] All rights of value under the patent (or an undivided interest in those rights) must be transferred. A sale of a patent will arise whenever the owner conveys the exclusive right to make, use, offer for sale, and sell an invention and, if the patented subject matter is a process, to exclude others from using, offering for sale, or selling products made by the process.[11]

The terminology used in the instruments of transfer is not the controlling factor – rather, it is the substance of the transaction that is of importance. Similarly, the retention of legal title as a security device is not inconsistent with the concept of a sale.

Because of the favorable treatment given to holders of patents under Code §1235(a), income tax regulations[12] provide that the following transactions are not sales:

- Any grant of rights to a patent that is limited geographically within the country of issuance
- Any grant of rights to a patent that is limited in duration by the terms of the agreement to a period less than the remaining life of the patent
- Any grant of rights to a patent that grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent that exist and that have value at the time of the grant
- Any grant of rights to a patent that grants less than all the claims or inventions covered by the patent that exist and that have value at the time of the grant

For taxpayers other than "holders," case law applies a standard that is less strict than the rule in the regulations. Transfers of interests in patents subject to geographical limitations and field of use restrictions, taken alone, will not require that the transfers be characterized as licenses. For example, a sale occurred when the

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9 Code §1212(a).

10 S. Rep't No. 1662, 83d Cong., 2d Sess., 439–440, 1954 U.S. Code Cong. & Admin. News 5082.

11 *Buckley v. Commr.*, 57-1 USTC ¶ 9525 (DC Wash. 1957).

12 Treas. Reg. § 1.1235-2(b)(1).

transferor of a patent granted the exclusive right to make, use, offer for sale, and sell a patented invention in the area west of the Mississippi River despite the fact that the transferor retained all of those rights in all other geographic regions.[13] Courts have also treated the transfer of exclusive rights to make, use, offer for sale, and sell a patented invention to a particular industry as a sale when the transferor retained all of those rights with respect to all other industries.[14]

"Payment does not determine whether the transfer of patent rights is a sale or license..."

Payment does not determine whether the transfer of patent rights is a sale or license. The I.R.S. recognized in Rev. Rul. 58-353 that a purchase price contingent on the use or exploitation of a patent is not inconsistent with the treatment of a transfer as a sale. However, a transfer may fail to possess the required characteristics of a sale when payments resembling royalties are received and other rights in the transferred interest are retained by the transferor.

Although an undivided interest is conveyed, the transfer of patent rights may receive license treatment if the parties do not share the same rights. In *Eickmeyer v. U.S.*,[15] the court found the transfer constituted a license because the transferee's right to the entire award in an infringement suit was inconsistent with the co-ownership of the patent under which all owners would share in any recovery in proportion to each owner's respective interest. On the other hand, in *Graham v. Commr.*,[16] a transferee's right to retain the entire recovery in an infringement action was held not to be inconsistent with co-ownership of the patent where the parties expressly provided that such awards are part of the contract price.

Case law and I.R.S. rulings are also consistent in characterizing the transfer of an undivided interest in all rights under the patent as a sale of those rights. While there appears to be no limit on the divisibility of a patent, courts have taken a skeptical view of so-called elastic proportions, in which co-ownership interests are conveyed without reflecting any particular percentage interest or under which the original transferor may convey unlimited undivided interests.

A transfer of a purportedly undivided interest in a patent that expressly permitted the transferee to assign or sublicense its interest is not a sale, but a license. Similarly, a requirement in a transfer agreement that a subsequent assignee must account to the original transferor is inconsistent with the transfer of a co-ownership interest. Finally, a transfer is usually a license if the right to sue for infringement in the transferee's own name is not granted.[17] However, the case law is not consistent where facts differ in material ways. For example, the right to sue may be considered a security device that does not preclude sale treatment.[18]

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13 *Crook v. United States*, 135 F. Supp. 242 (WD Pa. 1955); see also *Marco v. Commr.*, 25 TC 544 (1955).

14 See *Merck & Co. v. Smith*, 261 F2d 162 (3d Cir. 1958); *United States v. Carruthers*, 219 F2d 21 (9th Cir. 1955); *Kavanagh v. Evans*, 188 F2d 234 (6th Cir. 1951); *First Nat'l Bank of Princeton v. United States*, 136 F. Supp. 818 (DNJ 1955).

15 *Eickmeyer v. United States*, 86-2 USTC ¶ 9623 (Cl. Ct. 1986).

16 *Graham v. Commr.*, 26 T.C. 730 (1956).

17 *Oak Mfg. Co. v. United States*, 301 F2d 259 (7th Cir. 1962).

18 *Graham v. Commr.*, supra.

I.R.S. MEMORANDUM

The I.R.S. memorandum asserts that the 2006 contract between Mylan and Forest is a license, that the 2008 amendment continued the license with amended terms, and that payments made pursuant to both documents are therefore ordinary income.[19] The memorandum bases most of its arguments on the principles of contract law interpretation. According to the I.R.S., the 2006 contract and 2008 amendment had unambiguous language that made it clear the agreements were for a license rather than a sale.

- The preamble to the 2006 contract explained that:

  > Mylan has agreed to grant certain licenses and sublicenses relating to the subject matter of the Janssen Contract to Forest and Forest has agreed to make certain payments in connection with such grants and to perform the further activities contemplated hereby.

- Article 2.1 referred to the grant as a license. It stated:

  > *License*. Mylan hereby grants to Forest an exclusive license and sublicense, as the case may be, to the Licensed Patents and Licensed Know How in the Territory and outside the Territory for the limited purpose of manufacturing products containing nebivolol for Commercialization in the Territory. [Footnotes deleted.]

- Article 2.2. stated: "*Trademark License*. Mylan hereby grants to Forest an exclusive license to use the Trademarks."
- Article 2.3, headed "*Sublicensing*," detailed conditions under which "[t]he licenses hereby granted may be sublicensed by Forest."
- Article 6.1, which discusses generics, referred to "the exclusive license grants contained in this Agreement."
- Article 10 provided for the payment of royalties based on aggregate net sales of nebivolol products.
- In article 12.1(a), Mylan represented that "it has the right to grant the other Party the licenses and sublicenses granted pursuant to this Agreement."
- In article 12.1(c), Mylan represented that no legal or contractual conflicts interfere with "the licenses and sublicenses to be granted" pursuant to the contract.
- In article 12.2(a), Mylan represented that it "has not previously granted any rights that are inconsistent with the rights and licenses granted herein."
- Article 14.4, which deals with Forest's right of termination, referred to the "payment of any license fee" and the "value of licenses."

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[19] *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *memorandum*, Sept. 16, 2015.

Based on the principles of contract interpretation, the I.R.S. asserted that it is clear from the language used in the 2006 contract that the parties intended to enter into a licensing agreement and that the 2008 amendment is merely an extension of that agreement. The extension of a license does not change the substance of a contract from being that of a license into that of a sale. The I.R.S. reiterates that the 2008 amendment made no mention of sale or intent to sell the rights to nebivolol. Although the terms are not determinative of whether an agreement is a sale or license, the I.R.S. contends that the terms are "indicative of Mylan's intent."[20]

The I.R.S. refers to the Form 906, *Closing Agreements on Final Determination Covering Specific Matters*, that Mylan entered into with the I.R.S. for the payments it received from Forest in 2006 and 2007. On the Form 906, Mylan admits the 2006 contract was not a sale in order to defer recognition of the advance payments it received. The I.R.S. reiterates that the Form 906 proves the 2006 contract was a license. Since the 2008 amendment modified some terms but did not alter the license arrangement, the 2008 amendment is still a license that generates ordinary income.[21]

The I.R.S. also asserts that the "Danielson Rule" is applicable. In Commr. v. Danielson, the Third Circuit held that a taxpayer may challenge the tax consequences of its own contract only by introducing evidence that would invalidate the contract itself. This line of reasoning is supported by Supreme Court decisions, such as Commr. v. National Alfalfa Dehydrating & Milling Co.

The conclusion of the I.R.S. memorandum summarizes its position as follows:

> The language of the 2006 Contract and 2008 Amendment clearly shows that Mylan intended to license its rights to Forest, not to sell them to Forest. The 2006 Contract was, in form and function, a license agreement. The 2008 Amendment did not transform what had been a license into a sale. Rather, it continued the parties' license agreement with amended terms. Accordingly, respondent's motion for summary judgment should be granted and the Court should find that payments made by Forest to Mylan from 2008 through 2011 were ordinary income to Mylan.[22]

The strength of the I.R.S. arguments is open to challenge. The focus on the repeated use of the term "license" seems to be overly simplistic. If there is any point that is clear in the case law, it is that use of a label is not controlling. *In Taylor v. Commr.*, TC Memo 1970-325, the I.R.S. relied on similar arguments only to find they were dismissed by the court.

> We note at the outset that the agreements were drafted as 'licenses,' that the parties were identified therein as 'licensor' and 'licensee,' and that the periodic payments were termed 'royalties.' Although the use of this terminology indicates a license arrangement rather than a completed assignment or sale, such language, while of some

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[20] *Id.*

[21] *Id.*

[22] *Id.*

> weight, is not controlling. We must look to the substance of what the parties have put together.

It was only when the court evaluated the rights retained by the transferor that it concluded certain transactions were licenses.

> It has generally been considered necessary to transfer the exclusive right to *manufacture*, *sell*, and *use* patented property in order for a grant of an interest in the patent to qualify as a sale—at least where such rights are considered 'substantial.' * * * We think that [as to some but not all of the agreements,] petitioner failed to transfer the exclusive right to manufacture, sell, and use his manhole covers.

In the *Taylor* case, the court addressed a fact pattern in which one of the license agreements was modified several times and it was only upon the last of the agreements that all substantial rights were transferred. The court had no difficulty in concluding that by the completion of the last amendment, all substantial rights to patent were transferred.

CONCLUSION

The memorandum of law fails to explain why any or all of the rights retained by Mylan are substantial rights. These rights included (i) the right to purchase nebivolol from Janssen and to supply it to Forest, the right to receive information and documents involving regulatory authorities; (ii) the right to participate in Forest's meetings with regulatory authorities, and to provide input towards Forest's marketing plans, strategies, and pricing; (iii) the right to prevent Forest from discounting nebivolol in order to promote sales of other products; and (iv) the co-exclusive right with Forest to develop and commercialize nebivolol for the treatment of migraine headaches. It may be that such arguments raise questions of fact that would preclude the granting of summary judgment by the Tax Court. Instead, the I.R.S. focused on labels used in the two license agreements and as a result, the memorandum of law is unconvincing. A question of fact exists and a full trial is to be expected.

Mylan's response to the I.R.S. summary judgment motion is due in October.