Rev. Rul. 64-56

The Internal Revenue Service has received inquiries whether technical "know-how" constitutes property which can be transferred, without recognition of gain or loss, in exchange for stock or securities under section 351 of the Internal Revenue Code of 1954.

The issue has been drawn to the attention of the Service, particularly in cases in which a manufacturer agrees to assist a newly organized foreign corporation to enter upon a business abroad of making and selling the same kind of product as it makes. The transferor typically grants to the transferee rights to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. The transferor also often agrees to furnish technical assistance in the construction and operation of the plant and to provide on a continuing basis technical information as to new developments in the field.

Some of this consideration is commonly called "know-how." In exchange, the transferee typically issues to the transferor all or part of its stock.

Section 351 of the Code provides, in part, as follows:

(a) General Rule.-No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property. (Emphasis added.)

Since the term "know-how" does not appear in section 351 of the Code, its meaning is immaterial in applying this section, and the Service will look behind the term in each case to determine to what extent, if any, the items so called constitute "property

*** transferred to a corporation

*** in exchange for stock."<Page 134>

The term "property" for purposes of section 351 of the Code will be held to include anything qualifying as "secret processes and formulas" within the meaning of sections 861(a)(4) and 862(a)(4) of the Code and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for (see G.C.M. 21507, C.B. 1939-2, 189; Wall Products Inc. v. Commissioner,11 T.C. 51, at 57 (1948), acquiescence, C.B. 1949-1, 4; Ralph L. Evans v. Commissioner,8 B.T.A. 543 (1927), and without regard to whether it is patentable in the patent law sense (see Marvin R. Thompson v. Johnson, United States District Court for the Southern District of New York, entered July 26, 1950, 50-2, U.S. Tax Cases, paragraph 9428, 42 American Federal Tax Reports 1284). Other information which is secret will be given consideration as "property" on a case-by-case basis.

The fact that information is recorded on paper or some other physical material is not itself an indication that the information is property. See, for example, Harold L. Regenstein, et ux. v.

Commissioner,35 T.C. 183 (1960), where the fact that a program for providing group life insurance to Federal Government employees was transmitted in the form of a written plan did not preclude a finding that the payment for the plan was a payment for personal services.

It is assumed for the purpose of this Revenue Ruling that the country in which the transferee is to operate affords to the transferor substantial legal protection against the unauthorized disclosure and use of the process, formula, or other secret information involved.

Once it is established that "property" has been transferred, the transfer will be tax-free under section 351 even though services were used to produce the property. Such is generally the case where the transferor developed the property primarily for use in its own manufacturing business. However, where the information transferred has been developed specially for the transferee, the stock received in exchange for it may be treated as payment for services rendered. See Regenstein, supra, where the taxpayer developed a plan for selling insurance which he ultimately sold to certain insurance companies. The court held that the consideration received was payment for services.

Where the transferor agrees to perform services in connection with a transfer of property, tax-free treatment will be accorded if the services are merely ancillary and subsidiary to the property transfer. Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact. Ancillary and subsidiary services could be performed, for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective "starting-up" of the property transferred, or by performing under a guarantee relating to such effective starting-up. Compare Raymond M. Hessert v. Commissioner, Tax Court Memorandum Opinion, entered October 31, 1947, and Arthur C. Ruge, et ux. v. Commissioner,26 T.C. 138, at 143 (1956), acquiescence, C.B. 1958- 2, 7. Where both property and services are furnished as consideration, and the services are not merely ancillary and subsidiary to the property transfer, a reasonable allocation is to be made.

Training the transferee's employees in skills of any grade through expertness, for example, in a recognized profession, craft, or trade is <Page 135> to be distinguished as essentially educational and, like any other teaching services, is taxable when compensated in stock or otherwise, without being affected by section 351 of the Code. However, where the transferee's employees concerned already have the particular skills in question, it will ordinarily follow as a matter of fact that other consideration alone and not training in those skills is being furnished for the transferor's stock.

Continuing technical assistance after the starting-up phase will not be regarded as performance under a guarantee, and the consideration therefor will ordinarily be treated as compensation for professional services, taxable without regard to section 351 of the Code. Compare Paulsen Spence, et ux. v. United States,156 Fed. Supp. 556, at 560 (1957), where the Hessert and Ruge cases were distinguished and compare Kimble Glass Company v. Commissioner,9 T.C. 183 at 189 (1947), acquiescence, C.B. 1947-2, 3.

Assistance in the construction of a plant building to house machinery transferred, or to house machinery to be used in applying a patented or other process or formula which qualifies as property transferred, will ordinarily be considered to be in the nature of an architect's or construction engineer's services rendered to the transferee and not merely rendered on behalf of the transferor in producing, or promoting the sale or exchange of, the things transferred. Similarly, advice as to the lay-out of plant machinery and equipment may be so unrelated to the particular property transferred as to constitute no more than a rendering of advisory services to the transferee.

The transfer of all substantial rights in property of the kind hereinbefore specified will be treated as a transfer of property for purposes of section 351 of the Code. The transfer will also qualify under section 351 of the Code if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding that rights are retained as to some other country's territory. See Lanova Corporation v. Commissioner,17 T.C. 1178 (1952), acquiescence, C.B. 1952-1, 3.

The property right in a formula may consist of the method of making a composition and the composition itself, namely the proportions of its ingredients, or it may consist of only the method of making the composition. Where the property right in the secret formula consists of both the composition and the method of making it, the unqualified transfer in perpetuity of the exclusive right to use the formula, including the right to use and sell the products made from and representing the formula, within all the territory of the country will be treated as the transfer of all substantial rights in the property in that country.

The unqualified transfer in perpetuity of the exclusive right to use a secret process or other similar secret information qualifying as property within all the territory of a country, or the unqualified transfer in perpetuity of the exclusive right to make, use and sell an unpatented but secret product within all the territory of a country, will be treated as the transfer of all substantial rights in the property in that country.<Page 136>

Revenue Ruling 55-17, C.B. 1955-1, 388, is modified to remove the implication that payments for the rights described there as "know- how" will be treated as royalty income without regard to the factors applied here to determine whether such rights constitute property.

Nothing hereinbefore stated should be construed as limiting in any way the effective operation of other sections of the Internal Revenue Code upon transactions between domestic and related foreign corporations. See, for example, sections 367, 482, and 1491.