TAX 101:
TAXATION OF INTELLECTUAL PROPERTY – THE BASICS

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INTRODUCTION

Change driven by development of intellectual property ("I.P.") is now a constant. Whether the I.P. user is a tax adviser accessing a digital library, an auto mechanic interfacing with an engine, or a shopper looking for a specific brand of product, I.P. in all its varied forms serves as an important tool in daily life.

For purposes of U.S. tax law, I.P. can take many forms. As embodied in the Internal Revenue Code ("Code"),[1] I.R.S. regulations, and case law, it includes patents, trademarks, copyrights, trade secrets, know-how, and computer software.[2]

This article presents an overview of the basic U.S. Federal tax considerations of transactions that occur over the life cycle of I.P, from its creation, to its acquisition, its exploitation, and its ultimate sale in a liquidity event.

TAX CONSIDERATIONS OF SELF-CREATED I.P.

Basis

Deduction v. Capitalization

A taxpayer that creates and utilizes I.P. as part of a profitable ongoing trade or business likely will prefer deducting the costs attributable to creating the I.P. This treatment allows the taxpayer to obtain a current tax benefit for the tax year during which the research and development ("R&D") costs were paid or incurred. The Code permits a current deduction under Code §162 for all the ordinary and necessary expenses paid or incurred during the tax year in any trade or business. To be deductible under Code §162, a business expense must not be subject to a provision of the Code that requires capitalization, such as Code §263 or Code §263A.

If the Code requires that the costs incurred by a taxpayer in the creation of I.P. must be capitalized, the capitalized costs will form the taxpayer's basis in the I.P. However, if the costs may be deducted under the Code when and as incurred, the accelerated tax benefit prevents the expenditure from being part of the taxpayer's basis in the I.P. Consequently, a taxpayer may have zero basis in self-created I.P. if all the costs incurred in creating the asset were deducted.

Case law and Code §263 require the capitalization of a business expense if that

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1 All references to the Code refer to the Internal Revenue Code of 1986, as amended since that date.

2 Under the Code, I.P. is described as part of the broader category of "intangible assets."

expense will create or enhance a separate and distinct intangible asset, or create or enhance a future benefit beyond the tax year in which the expense is incurred.

The Regulations under Code §263 generally require that amounts paid to create or acquire an intangible asset must be capitalized.[3] Amounts paid to facilitate the creation or acquisition of an intangible asset also must be capitalized.[4] The regulations list some of the costs related to self-created intangible assets that must be capitalized. The most significant in the context of I.P. are (i) costs incurred to obtain rights from a governmental agency, such as costs to obtain, renew, renegotiate, or upgrade rights under a trademark, trade name, or copyright and (ii) costs to defend or perfect title to an intangible asset, such as the cost to settle a patent infringement lawsuit.[5]

Code §263A requires the capitalization of a variety of costs attributable to property produced by a taxpayer or acquired for resale in a trade or business or an activity conducted for profit. For the purposes of Code §263A, "property" is defined to include tangible property, which would seem to exclude I.P. However, tangible property under Code §263A includes films, sound recordings, videotapes, books, and similar property that is intended to be produced on a tangible medium and mass distributed in a form that is not substantially altered. Thus, for example, the cost of writing a book, including the cost of producing a manuscript and obtaining a copyright or license for the project, must be capitalized pursuant to Code §263A.

Research Expenses

Code §174 provides a current deduction for certain types of research and experimental ("R&E") expenses. Under this section, a taxpayer may elect to (i) currently deduct all R&E expenses made in connection with the taxpayer's trade or business or (ii) amortize the expenditures over a period of not less than 60 months beginning with the month in which the taxpayer first realizes benefits from the expenditures. For taxpayers operating at a loss, the deferral of the 60-month amortization period may provide a more valuable tax benefit. If neither election is made, the expenditures are merely capitalized into the basis of the I.P., eliminating any tax benefit until the I.P. is sold.

Code §174 actually applies more broadly than Code §162 because it is available to taxpayers who are not yet engaged in a trade or business. R&E expenses must be R&D costs in the experimental or laboratory sense – that is, activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Thus, for example, the cost of creating a patentable pharmaceutical product may be currently deducted under Code §174.

Startup Expenses

Many I.P. companies are "startups," working on developing and testing a new I.P. asset, with the hope that it will soon attract investors and customers. Expenses related to starting a new business generally are not deductible under Code §162 because the taxpayer is not yet engaged in carrying on a trade or business. Code §195 allows taxpayers to elect to defer deducting certain expenses incurred before

3 Code §1.263(a)-4(b)(1).

4 Code §1.263(a)-4(b)(1)(v).

5 Code §§1.263(a)-4(d)(5), (9).

the business becomes active and to deduct such expenses over a 15-year period beginning with the month in which the active business begins. Startup expenses are limited to costs that would be deductible if the business was already an active trade or business.

Amortization

Self-created I.P. used in a trade or business or held for the production of income may qualify for an amortization deduction under Code §167. The amount subject to the amortization deduction is the taxpayer's basis in the property. As discussed above, a taxpayer may not have a basis in self-created I.P. because the costs incurred to create the asset were currently deductible. The amortization deduction for self-created I.P. is available in cases in which a taxpayer was required to amortize the costs incurred in creating the I.P.

Code §167

The regulations state that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, which can be estimated with reasonable accuracy, the intangible asset may be amortizable under Code §167. The regulations specifically state that patents and copyrights have a useful life that can be reasonably estimated.[6] In contrast, trade secrets and know-how generally have been held to not have limited useful lives because they remain valuable as long as they remain confidential.

"Self-created I.P. used in a trade or business or held for the production of income may qualify for an amortization deduction under Code §167."

The issues of (i) whether certain intangible assets have useful lives and (ii) the lengths of the useful lives of certain intangible assets have been the subjects of controversy. The regulations under Code §167 created some certainty by providing a safe harbor for certain intangible assets.

Under the safe harbor, a taxpayer may treat an intangible asset as having a useful life of 15 years, unless (i) another useful life is specifically prescribed or prohibited under the tax law, (ii) the intangible asset is acquired from another person or is a financial interest, (iii) the intangible asset has a useful life that can be reasonably estimated, or (iv) the intangible asset relates to certain benefits arising from real property.[7] The basis of an intangible asset subject to the safe harbor must be amortized ratably over the 15-year period.[8]

Code §197

Code §197 generally applies to acquired intangible assets, typically in connection with the acquisition of a business as part of an asset purchase transaction. However, it also applies to a limited class of self-created intangible assets that are not part of an acquisition of a business. The class of self-created assets includes trademarks and trade names.[9] Thus, to the extent that costs incurred to create such

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6 Code §1.167(a)-3.

7 Code §1.167(a)-3(b)(1).

8 Code §1.167(a)-3(b)(3).

9 Code §197(c)(2) and (d)(1)(F). Other self-created intangible assets that may be amortized under Code §197 include (i) licenses, permits, and other rights granted by a governmental unit and (ii) any covenant not to compete entered into in connection with the acquisition of a trade or business. See generally Code §§197(c)(2) and (d)(1)(D), and (E).

assets must be capitalized under general tax principles, Code §197 will apply to determine the period over which the capitalized costs will be amortized for income tax purposes.

TAX CONSIDERATIONS OF ACQUIRED I.P.

Basis

In General

Generally, a taxpayer's basis in an acquired asset, including an intangible asset, will be the amount paid for the asset. In an arm's length transaction, the amount paid should be the acquired asset's fair market value as determined in an independent transaction. If a taxpayer acquires a single asset, the basis of that asset will be the purchase price. If the taxpayer acquires multiple assets from a seller or a trade or business, the acquirer and the seller might not have made an asset-by-asset allocation of the purchase price but simply agreed on an aggregate purchase price for the entire group of assets. In such a case, the acquirer must determine the fair market value of each asset through appraisals.

Direct Acquisition of the Intangible Assets of a Trade or Business

A trade or business may be acquired either directly through an asset acquisition or indirectly through the acquisition of the stock of a corporation. An asset acquisition offers the benefit of receiving a stepped-up cost basis in the assets, equal to the amount of the consideration paid. This maximizes future deductions for amortization and basis offset for assets that are subsequently sold. The drawback of an asset acquisition is that the legal documents typically are more complicated than in an acquisition of stock.[10] Further, as discussed below, under a special election procedure, the taxpayer may achieve the basis step-up of a direct acquisition in a stock acquisition.

When a taxpayer acquires an intangible asset as part of the direct acquisition of assets comprising a trade or business, the bases of the acquired assets are determined under the rules of Code §1060 and the regulations issued by the I.R.S. under that provision. Code §1060 applies to an "applicable asset acquisition," which is defined as any direct or indirect transfer of a group of assets that constitutes a trade or business in the hands of either the acquirer or the seller, and the acquirer's basis in the assets is determined wholly by reference to the consideration paid.

The acquired assets are divided into seven classes, typically referred to under the regulations as Class I through Class VII. Intangible assets, such as I.P., typically would fall into Class VI. The basis is allocated among the assets under a method by which the consideration is first reduced by the amount of Class I assets, and any remaining consideration is then allocated among the assets by ascending class number in an amount generally not in excess of fair market value of the assets within each class. Thus, after the allocation of the purchase price to Class I assets is completed, the purchase price is allocated to Class II assets to the extent of their respective fair market values, and so forth until the balance of the purchase price is allocated to Class VII assets.

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10 Stock transactions have their own complexities in connection with good legal title to assets owned and the exposure to hidden liabilities and claims.

The application of the basis allocation rules of Code §1060 imposes significant reporting requirements on both transferor and transferee, particularly with respect to Code §197 intangible assets, because the I.R.S. is interested in identifying situations in which the transferor and transferee report inconsistent allocations in order to maximize their respective tax benefits.

Acquisition of a Trade or Business Through a Stock Acquisition

In an acquisition of stock, the acquirer generally will have a cost basis in the acquired corporation's stock equal to the consideration paid for the stock. The consideration paid by the acquiring taxpayer will not be reflected through an increase or decrease in the basis of the acquired corporation's assets. Thus, for example, if the consideration paid by a taxpayer to acquire all of the stock a corporation exceeds the aggregate basis of the corporation's assets, neither the taxpayer nor the acquired corporation will be entitled to increase the basis in the corporation's assets.

Code §338 permits a taxpayer to make an election to treat certain stock acquisitions as asset acquisitions for the purposes of obtaining basis step-up in the underlying assets of the acquired corporation. The basis is allocated among the assets of the acquired corporation under rules similar to the rules described above, in which basis is first allocated to one class of assets and will continue to be allocated among the assets by ascending class number.

Acquisition Costs

The regulations under Code §263 state that a taxpayer must capitalize amounts paid to another party to acquire any intangible asset in a purchase or similar transaction, and specifically list certain intangible assets as falling under that rule. Examples are (i) a patent or copyright; (ii) a franchise, trademark, or trade name; and (iii) computer software.[11]

Amortization

In General

The amortization of acquired intangible assets is largely governed by Code §197, which permits a taxpayer to amortize any "amortizable Code §197 intangible" ratably over a 15-year period starting with the month in which the intangible asset is acquired. The 15-year amortization period applies regardless of the taxpayer's ability to establish the asset's limited useful life.

An amortizable Code §197 intangible is any "Code §197 intangible" held in connection with the conduct of trade or business or the production of income. A Code §197 intangible is defined to specifically include any and all of the following items:

- Patents
- Copyrights
- Formulas

[11] Treas. Reg. §§1.263(a)-4(c)(vii), (viii), and (xiv). The full list overlaps with intangible assets covered under Code §197, as explained later in the text under amortization.

> *“Acquired I.P. will be either an amortizable Code §197 intangible asset or an intangible asset excluded from Code §197 but possibly amortizable under Code §167.”*

- Processes
- Designs
- Patterns
- Know-how
- Formats or other similar items
- Franchises, trademarks, or trade names

In addition, a license, contract, or other arrangement for the use of a Code §197 intangible is itself a Code §197 intangible (unless the underlying asset is otherwise excluded from Code §197).

Special Rules for Licenses of Code §197 Intangibles

If the rights to use a Code §197 intangible are acquired in a *bona fide* license that is part of the acquisition of a trade or business, payments made pursuant to the license must be capitalized and amortized under Code §197. In contrast, if the rights to use a Code §197 intangible are acquired in a *bona fide* license that is not part of the acquisition of a trade or business, payments made pursuant to the license may be deducted rather than capitalized. As discussed in detail below, under certain circumstances, the I.R.S. may challenge a purported license as a sale of an intangible asset.

I.P. Excluded from the Application of Code §197

Two categories of assets are specifically excluded from the application of Code §197:

- Assets excluded regardless of the means by which the assets are acquired
- “Separately acquired assets” (defined below)

In the I.P. context, assets in the first category include certain computer software, sometimes referred to as “off-the-shelf” computer software. This is software that meets the following criteria:

- Readily available for purchase by the general public
- Subject to a nonexclusive license
- Has not been substantially modified

Examples include word processing software used by a law firm or general office of a company. Such computer software typically has a limited useful life that is much less than 15 years and may be amortized under Code §167 over a period of 36 months.

Separately acquired assets are intangible assets acquired in a transaction or a series of related transactions that do not involve the acquisition of the assets constituting a trade or business or a substantial portion of a trade or business. Typically, the fact pattern includes the expansion of an existing business, rather than the acquisition of an entirely new business. These assets may include patents, copyrights, computer software, and any interest in a film, sound recording, video tape, book, or similar property. Such separately acquired assets will typically be amortized under Code §167.

Nonrecognition Transactions

If a Code §197 intangible is acquired in a nonrecognition transaction, such as the contribution of property to a corporation that is free of immediate tax for the transferor under Code §351, or a comparable transfer of property to a partnership that is free of immediate tax for the transferor under Code §721, the transferee generally will step into the shoes of transferor with respect to the Code §197 intangible. To the extent basis is increased in the transaction because of the nature of a portion of the consideration received by the transferor, the transferee is treated as receiving two assets. The first asset has a basis equal to the basis of the Code §197 intangible in the hands of the transferor, while the second asset has an increased basis resulting from the gain partially recognized by the transfer. The former asset will be amortized over the remaining amortization period, and the latter asset will be amortized over a newly started 15-year amortization period.

TAX CONSIDERATIONS OF SALES OF I.P.

Character of Gain or Loss

In General

Under general tax principles, a taxpayer will realize gain on the sale of property to the extent that the amount realized on the sale exceeds the taxpayer's adjusted basis in the property. The taxpayer will realize loss to the extent that the adjusted basis in the property exceeds the amount realized on the sale. In certain instances, a nonrecognition rule of the Code may defer immediate recognition of gain or loss.

As discussed in detail below, the characterization of the gain or loss – that is, whether it is capital gain or loss, or ordinary gain or loss – will depend on three factors:

- The type of asset involved (*e.g.*, depreciable v. not depreciable)
- The purpose for which it was held by the taxpayer (*e.g.*, for investment v. for sale to customers)
- The nature of the parties involved in the transaction (*e.g.*, related v. unrelated)

Recapture as Ordinary Income

Depreciable or amortizable property generally will be subject to a recapture provision, such as Code §1245, which will require the taxpayer to characterize some or all of the gain (but not the loss) as ordinary gain. The recapture rules of Code §1245 apply to tangible and intangible assets that may be amortized under Code §167. Since many self-created and acquired intangible assets are amortizable under Code §167 and all Code §197 intangible assets are treated as subject to Code §167, Code §1245 will impact the characterization of gain on the sales of many types of intangible assets. Under Code §1245, any gain attributable to previously taken amortization deductions must be characterized as ordinary income.

After applying the recapture rules of Code §1245, any remaining gain recognized on the sale – or the loss, if the property is sold for less than the amortized basis immediately prior to the transaction – must be analyzed under the rules of Code §§1221 and 1231 to determine its character (ordinary or capital) and, consequently, how it will be taxed. For a taxpayer that is an individual, ordinary income is taxed at rates up to 39.6% under current law. The capital gains of an individual taxpayer are taxed at preferential rates, typically 20%. In contrast, ordinary income and capital gains of a corporation are taxed at the same rate; the highest tax rate currently is 35%. Moreover, capital losses generally are available to reduce only capital gains, subject to a minor amount that can be applied to reduce ordinary income when the taxpayer is an individual. Therefore, the characterization of gain and loss is important.

"Losses and gains from sales or exchanges of property described in Code §1231 are subject to complicated netting rules."

Capital Asset Defined

Broadly speaking, if the property is a capital asset in the hands of the taxpayer, the remaining gain – or the total loss – on a sale or exchange will be characterized as capital gain or loss. Code §1221 provides the definition of a capital asset and contains exclusions that are important in the context of I.P. For example, (i) inventory or (ii) property that is used in a trade or business and subject to depreciation under Code §167 is not a capital asset under Code §1221. Also, certain property, including a copyright or a literary, musical, or artistic composition, held by an individual taxpayer whose personal efforts created the property (or a person in whose hands the basis of the property is determined, in whole or in part, by reference to the basis of the property in the hands of the person who created it) is not a capital asset. This exclusion prevents creators that are not engaged in a trade or business from receiving capital gains treatment when the same type of person engaged in a trade or business would not receive such treatment.

Code §1231 Special Treatment

Code §1231 generally applies to property used in a trade or business, subject to the allowance for depreciation under Code §167, and held for more than one year. However, like Code §1221, Code §1231 excludes (i) inventory, (ii) property held for sale to customers in the ordinary course of a trade or business, and (iii) certain property, including a copyright or a literary, musical, or artistic composition, held by the taxpayer whose personal efforts created the property (or a person in whose hands the basis of the property is determined, in whole or in part, by reference to the basis of the property in the hands of the person who created it) is not a capital asset.

Losses and gains from sales or exchanges of property described in Code §1231 are subject to complicated netting rules. In broad terms, if losses are netted against gains and the result is a net loss, both the losses and gains are treated as ordinary gains or losses. If instead, the result is a net gain, both the losses and gains are treated as capital gains or losses.

Self-created I.P.

As previously discussed, a taxpayer may have a zero basis in self-created I.P. if the costs incurred in creating the asset were deducted. In such a case, the taxpayer will realize gain to the full extent of the amount realized on the sale of the I.P.

Alternatively, the taxpayer may have a basis in the self-created I.P. if certain costs incurred in creating the asset were required to be capitalized. Where that occurs, the taxpayer will realize gain if the basis is less than the amount realized or loss if the basis is greater than the amount realized on the sale of the I.P.

Some self-created I.P. will be a capital asset in the hands of its creator. For example, self-created trade secrets and know-how will not be excluded from the definition of a capital asset under Code §1221 because trade secrets and know-how are not depreciable assets. Accordingly, any gain or loss from the sale will be capital gain or loss.

In contrast, self-created I.P. that is depreciable under Code §167 is specifically excluded from the definition of a capital asset under Code §1221, but it is not excluded from coverage under Code §1231. The asset will be subject to the depreciation recapture rules of Code §1245, so that any gain that is realized and is attributable to the previous amortization deductions will be characterized as ordinary gain. The remaining gain or loss may be characterized as capital gain or loss under Code §1231 if the asset was used in a trade or business, held for more than one year, and not otherwise excluded by Code §1231, as discussed above.

Illustration

> ***"Self-created I.P. that is depreciable under Code §167 is specifically excluded from the definition of a capital asset under Code §1221, but it is not excluded from coverage under Code §1231."***

In tax year 1, Taxpayer created a patent and deducted some of the R&D costs incurred in creating the patent under Code §174. The remaining costs were required to be capitalized under Code §263. As a result, Taxpayer received a basis in the self-created patent to the extent of those capitalized costs.

Taxpayer amortized the capitalized costs under Code §167, reducing its basis annually to the extent of the amortization deduction. At all times, Taxpayer used the patent in its trade or business, and the patent was not inventory or held primarily for sale to customers in the ordinary course of that trade or business. In tax year 5, Taxpayer sold the patent and realized gain. Taxpayer had no other sales during the tax year, and as a result, the realized gain was the net gain for the tax year. Under Code §1245, the gain attributable to the amortization deductions will be treated as ordinary gain. Under Code §1231, the remaining gain will be treated as capital gain.

Acquired I.P.

As discussed above, acquired I.P. will be either an amortizable Code §197 intangible asset or an intangible asset excluded from Code §197 but possibly amortizable under Code §167.

Since amortizable Code §197 intangible assets are treated as property subject to Code §167, any gain on the sale of the I.P. will be subject to depreciation recapture under Code §1245. The I.P. generally will not be a capital asset under Code §1221, but if it is used in a trade or business, held for more than one year, and otherwise not excluded from Code §1231, any gain or loss on the sale of the I.P. may be treated as capital gain or loss under Code §1231.

As discussed in detail below, certain special rules of the Code may recharacterize the gain or loss. Further, Code §197 includes certain loss disallowance rules.

In the case of assets excluded from Code §197, such as certain computer software discussed above, and not subject to depreciation under Code §197 but subject to depreciation under Code §167, any gain on a sale will be subject to Code §1245 depreciation recapture and the gain or loss may be capital under the rules of Code §1231. However, the Code §197 loss disallowance rules (discussed below) will not apply. Assets excluded from Code §197 and not depreciable would not be subject to depreciation recapture and may be capital assets under Code §1221.

Special Rules Involving Sales Between Related Parties

In a sale of I.P. between related parties, two issues are prevalent. For a sale at a loss, the issue is whether the loss is deductible, and if it is, whether the loss offsets capital gain or ordinary income. If the sale results in a gain, the issue is the character of the gain as ordinary or capital, reflecting the fact that the purchaser can reduce ordinary income through amortization of the acquisition price. Several provisions may be applicable. Regarding deductions, Code §§267 and 197 are relevant. Regarding the character of gains, Code §1239 is relevant.

Code §267 generally disallows losses on the sale or exchange of property between related parties, such as certain members of a family or corporations owned by the same shareholder. For the purposes of determining whether the purchaser and the seller are related, a taxpayer will be treated as owning property directly, indirectly, and constructively. The application of Code §267 is broad: It applies to sales or exchanges between related parties of self-created and acquired I.P.

Loss Disallowance Rules under Code §197

In addition, Code §197 contains a loss disallowance rule, which prohibits the recognition of loss on the sale or exchange of an amortizable Code §197 intangible asset if the taxpayer retains any other amortizable Code §197 intangible asset acquired in the same transaction or series of related transactions. The purpose of the loss disallowance rule is to prevent taxpayers from recovering unamortized basis faster than ratably over the 15-year amortization period available under Code §197. The disallowed loss is allocated to the retained assets as a basis increase.

Code §197 contains a special loss disallowance rule that applies to covenants not to compete. If a covenant not to compete is entered into in connection with the direct or indirect acquisition of an interest in one or more businesses, the disposition or worthlessness of the covenant will not be considered to occur until the disposition or worthlessness of all interests in those trades or businesses occurs.[12] This provision is intended to prevent a loss from being recognized in the year the covenant terminates, which typically is many years prior to the completion of the 15-year amortization period.

Regarding the character of gains, Code §1239 requires a transferor to treat any gain recognized on the sale or exchange of property as ordinary income if the property is depreciable under Code §167 in the hands of a related-partly transferee. The purpose is to prevent a tax arbitrage opportunity involving a gain taxed at preferential rates for individuals when amortization deductions offset ordinary income for the related party.

Sale or License

Intangible assets, particularly I.P., are frequently licensed, resulting in royalty income to the licensor, which is characterized as ordinary income. If the underlying intangible asset is amortizable, the licensor will continue to be able to amortize the asset notwithstanding the license agreement. On the other hand, if the transaction

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[12] Code §197(f)(1)(B); Treas. Reg. §1.197-2(g)(1)(iii).

has the economic effect of a sale but is legally characterized as a license, the seller can recover the full basis of the property right involved in the transaction.

A key question to consider in the taxation of a licensor transferring an exclusive license is whether, notwithstanding the form, the transfer should be treated as a sale of the intangible asset. Under an objective test, known as the "substantial rights test," a transfer of a license can be treated as a sale if the licensor relinquishes all substantial rights to the licensee. On the other hand, a transfer by sale can be treated as a license if it involves a transfer of a nonexclusive right to use an intangible asset, particularly for a period less than the estimated useful life of the asset. This question permeates all areas of I.P. and the conclusion may vary depending upon the type of I.P. asset that is involved.

<u>*Special Rule for Sale of a Patent*</u>

A special statutory rule applies to patents that apply to persons characterized as "holders." Under Code §1235, a holder of a patent, or an undivided interest in the patent, is any individual whose efforts created the invention and any other individual who acquired his or her interest in the property right in exchange for consideration in money or money's worth, provided the price is paid prior to the actual reduction to practice of the invention. In the latter set of circumstances, the acquirer cannot be the employer of the creator of the invention nor related to the creator within the broad meaning of Code §267(b) and certain other provisions, as adjusted by Code §1235. This provision was enacted to address an unwarranted benefit enjoyed by amateur inventors that was denied to professionals. The former class of individuals benefitted from capital gains tax rates on the sale of a patent while the latter was subject to U.S. tax at ordinary income tax rates.

"A transfer consisting of 'all substantial rights' to a patent . . . is considered to be a sale or exchange of a capital asset held for more than one year."

Under Code §1235, a transfer consisting of "all substantial rights" to a patent, or a transfer of an undivided interest in the patent, which includes a part of all the rights, is considered to be a sale or exchange of a capital asset held for more than one year. The actual holding period is irrelevant. Consequently, an individual who qualifies as a holder is entitled to compute tax on the gain from a sale of all substantial rights at favorable long-term capital gains rates. The consideration may be payable periodically with the transferee's use of the patent or contingent on the productivity, use, or sale of the patent.

All substantial rights mean all rights (whether or not then held by the grantor) that are of value at the time the rights to the patent (or an undivided interest therein) are transferred. Because the owner of a product patent owns the exclusive right to make, use, offer for sale, and sell an invention, the all substantial rights test is met when such patent owner sells the exclusive right to make, use, offer for sale, and sell an invention. In some circumstances described below, only one or another of the rights can be sold without jeopardizing application of Code §1235 for the holder.

Regulations issued by the I.R.S. establish certain hurdles that must be overcome for a transfer by license or sale to be considered a transfer of all substantial rights.[13] The regulations list grants of rights that fail to transfer all substantial rights in a patent. As a result, none of the following grants of rights under a patent satisfy the "all substantial rights test":

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[13] Treas. Reg. §1.1235-2(b).

- A transfer that is limited geographically within a country of issuance[14]
- A transfer that is limited in duration to a period less than the remaining life of the patent[15]
- A transfer that grants rights in fields of use within trades or industries that are less than all the rights covered by the patent that exist and have value at the time of the grant[16]
- A transfer that grants less than all the claims or inventions covered by the patent that exist and have value at the time of the grant[17]
- A transfer in which the transferor retains the right to terminate the transfer at will[18]

The regulations go on to provide that certain rights can be retained because they are not substantial. As a result, the following rights can be retained by a holder without violating the all substantial rights test:

- A legal title for the purpose of securing performance or payment by the transferee in a transaction involving a transfer of an exclusive license to manufacture, use, and sell for the life of the patent[19]
- Rights in the property that are not inconsistent with the passage of ownership (including a security interest such as a vendor's lien or a reservation of a right that is subject to a condition subsequent, such as a provision for forfeiture in the event of nonperformance)[20]

Because facts and circumstances control so many decisions in U.S. Federal tax law, the regulations provide that certain rights retained by the transferor may or may not be considered to be substantial rights under Code §1235 depending upon the circumstances of the whole transaction. These include the retention of an absolute right to prohibit sublicensing or sub-assignment by the transferee and the failure to convey to the transferee the right to use or to sell the patent property.[21] In the latter case, Code §1235 treatment may be jeopardized if the retained right is valuable, but it is allowed if the retained right is relatively valueless.

CONCLUSION

To understand the U.S. Federal tax considerations of I.P. it is important to first distinguish whether the asset was self-created or acquired.

If the I.P. is self-created, a taxpayer may be required to capitalize the costs incurred

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14 Treas. Reg. §1.1235-2(b)(1)(i).

15 Treas. Reg. §1.1235-2(b)(1)(ii).

16 Treas. Reg. §1.1235-2(b)(1)(iii).

17 Treas. Reg. §1.1235-2(b)(1)(iv).

18 Treas. Reg. §1.1235-2(b)(4).

19 Treas. Reg. §1.1235-2(b)(2)(i).

20 Treas. Reg. §1.1235-2(b)(2)(ii).

21 Treas. Reg. §1.1235-2(b)(3).

in creating the I.P. and amortize those costs over the asset's useful life, typically using straight line amortization over a 15-year period. Alternatively, the taxpayer may be permitted to deduct the costs of creating the I.P. on a current basis provided the cost qualify as deductible expenses.

If the I.P. is acquired from another, the taxpayer generally will have a basis in the asset equal to the amount paid to acquire the I.P. Acquired I.P. used in a trade or business or held for the production of income generally may be amortized under the rules of Code §197, which permits straight line amortization over a 15-year period. If such acquired I.P. is not amortizable under Code §197, it may nonetheless be amortizable under Code §167.

The sale of I.P. that is subject to amortization will require the taxpayer to recapture some or all of the gain as ordinary gain. Any remaining gain in excess of the recapture amount on the sale of the I.P., or loss incurred, may be characterized as capital or ordinary depending upon the type of asset involved, the purpose for which it was held by the taxpayer, and the parties involved in the transaction.