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Tax 101: Taxation of Intellectual Property—Selected Tax Issues Involving Corporations and Partnerships

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This article reviews the basic US Federal tax considerations of intellectual property (IP) taxation in the context of corporations and partnerships and examines some typical tax considerations when IP is held through a corporation or a partnership.

Corporations

Acquisitions

A corporation may acquire IP in several ways, including

- receiving a contribution of IP from a shareholder,
- purchasing or licensing the use of IP from another person, or
- creating IP in-house.

Under Internal Revenue Code (Code) § 351, a shareholder's contribution of property, such as IP, to a corporation will be tax-free if

- the transfer is solely in exchange for stock of the transferee corporation, and
- the transferor is in control of the transferee corporation immediately after the exchange, which for this purpose means ownership of 80 percent or more of the total value and 80 percent or more of the total voting rights with respect to the corporation's stock.

In a Code § 351 exchange, the transferee corporation's basis in the contributed IP will be the same as that of the transferor shareholder.

If the Code § 351 requirements are not met, the shareholder will recognize gain, but not loss, to the extent that the value of the stock exceeds his or her adjusted basis in the IP. Here, value of shares is closely associated with the value of the IP at the time of transfer. Any gain recognized by the transferor shareholder will be added to the transferee corporation's adjusted basis in the contributed IP. Examples of circumstances in which a shareholder will recognize gain in an otherwise tax-free Code § 351 exchange include a transfer where the transferor receives cash or other property in addition to the stock of the transferee corporation.

In the past, there was some doubt as to whether intangible assets, such as IP, constituted "property" for purposes of Code § 351. Though the issue has been settled in favor of the taxpayer, an issue that is not clear is whether a transfer of less than all substantial rights in the property, such as a transfer of a license to use the IP, is a tax-free transfer under Code § 351. In Revenue Ruling 69-156,[1] the Internal Revenue

Service (IRS) determined that the transfer by a domestic corporation of an exclusive right to import, make, use, sell, and sublicense a patent involving a chemical compound to its foreign subsidiary was not a transfer of "property" within the meaning of Code § 351. It stated that tax-free treatment under Code § 351 is only available when the rights transferred by the shareholder would constitute a sale, not a license, if the transfer were a taxable transfer.

In contrast, in *E.I. Dupont de Nemours v. U.S.*,[2] the Court of Claims held that a carved-out right to a non-exclusive license would qualify for tax-free treatment under Code § 351 and that there was no basis for limiting tax-free treatment under Code § 351 to transfers that would constitute sales or exchanges if they were not subject to a nonrecognition provision. The IRS has recognized that this case has precedential value and must be strongly considered, although it has not withdrawn the ruling.[3]

A shareholder's receipt of stock in exchange for services does not meet the requirements of Code § 351. However, if IP is transferred and the IP constitutes property for the purposes of Code § 351, the transfer will be tax free under Code § 351, even though the shareholder performed services to produce the property. Further, where the transferor shareholder agrees to perform services in connection with a transfer of property, the IRS determined that tax-free treatment under Code § 351 will be accorded if the services are "merely ancillary or subsidiary" to the transfer. These ancillary and subsidiary services could include promoting the transaction by demonstrating and explaining the use of the property, assisting in the "starting up" of the property transferred, or performing under a guarantee relating to the effective starting up.[4]

Under circumstances in which the shareholder must recognize gain on the IP transfer, the gain will be subject to the recapture rules of Code § 1245 if the IP was amortizable. The rules of Code § 1221 and § 1231 must be applied to determine whether the gain is ordinary income or capital gain.

A corporation may acquire IP as a separate asset or as part of a trade or business. In the case of separately acquired IP, the corporation's basis in the IP generally will be the purchase price. In the case of IP acquired as part of a trade or business, the corporation's basis in the IP will depend on whether the acquisition is an asset or stock acquisition. In the case of an asset acquisition, the purchase price must be allocated among the assets of the trade or business, including the IP, under the rules of Code § 1060.

In the case of a stock acquisition, the corporation will not receive a step-up in the basis of the underlying assets of the acquired corporation, unless it makes an election under Code § 338 to treat the stock purchase as an asset purchase. The purchase price will be allocated under rules similar to the rules of Code § 1060.

In the case of self-created IP where the corporation capitalizes the costs of developing the IP, the corporation will have a basis in the IP generally equal to the capitalized costs. As discussed below, this basis may be amortized. Alternatively, if the corporation is permitted to deduct all or some of the costs incurred in developing the IP, the corporation may have no basis or a very low basis in the IP.

Amortization

Corporations are subject to amortization rules for self-created and acquired IP. Thus, for example, under the rules of Code § 197, a corporation generally may amortize its basis in a broad list of acquired IP (including, patents, trademarks, trade names, trade secrets and know-how, copyrights, and computer software) if the acquired IP is used in a trade or business or an activity carried on for the production of income and was not separately acquired. Though corporate taxpayers have several choices in amortization methods, Code § 197 requires straight-line depreciation over a 15-year period. The rules of Code § 167 must be applied to determine the amortization permitted for a corporation's self-created and separately acquired IP.

In the case of contributed IP, one of two situations may arise:

1. A shareholder may contribute IP that was amortizable in the hands of the shareholder.
2. A shareholder may contribute IP that was not amortizable in the hands of the shareholder, such as certain self-created IP.

In the former case, the transferee corporation generally steps into the place of the transferor shareholder and, thus, receives a carryover basis, which must be amortized over the remainder of the original amortization period. If gain is recognized on the transfer, the transferee corporation's basis in the IP will equal the transferor shareholder's basis plus the recognized gain. The amortization of the IP will be bifurcated: The portion of the basis corresponding to the carryover basis will continue to be amortized over the remaining original amortization period, and the portion of the basis that corresponds to the recognized gain will be amortized under a new 15-year amortization period.

In the latter case, the corporation generally will not be permitted to amortize the contributed IP, unless the transferor recognizes gain. In that case, the recognized gain will be treated as a purchase price, and become the transferee corporation's basis in the IP, which may be amortized.

Dispositions

A corporation's disposition of IP may take several forms, including

- a sale of IP to an unrelated third party,
- a sale of IP to a shareholder, or
- a distribution of IP to a shareholder.

If a corporation sells amortizable IP to an unrelated third-party, any recognized gain attributable to the pre-sale amortization deductions will be characterized as ordinary income under the recapture rules of Code § 1245. Any remaining gain or loss may be characterized as either ordinary or capital under the rules of Code § 1221 or § 1231.

In the case of a sale to a shareholder owning a significant portion of the corporation, any gain in excess of the Code § 1245 recapture amount recognized on the sale will be treated as ordinary income under Code § 1239, which generally applies to the transfer of property from a corporation to a shareholder if the transferred property is depreciable or amortizable in the hands of the transferee shareholder and the shareholder is considered a related person. For the purposes of Code § 1239, the shareholder is a related person if it holds more than a 50 percent interest in the corporation.

If the shareholder does not meet the Code § 1239 ownership threshold, the recapture and characterization rules applicable to an unrelated third-party buyer will apply, as discussed above.

IP that is amortizable under Code § 197 is subject to a loss disallowance rule under Code § 197(f) that prevents the recognition of loss in the case of an asset that was acquired in a transaction or a series of transactions if, at the time of the disposition, the taxpayer retains the other intangible assets amortizable under Code § 197 that were acquired in the same transaction or series of related transactions. The purpose of this rule is to prevent taxpayers from recovering their basis faster than over the 15-year amortization period. The unrecognized loss is not completely forfeited, but rather, it is added to the bases of the remaining intangible assets and amortized over the remaining 15-year amortization period.

The following example illustrates the loss disallowance rule:

> In tax year 1, a corporation, C, acquires a trade or business, which includes IP assets. C receives a step-up in the basis of the IP assets and takes amortization deductions. C utilizes the IP assets in business line 1 and business line 2. Subsequently, in tax year 5, C decides to sell business line 1. The sale is structured as an asset sale and includes one of the IP assets acquired in the acquisition of the trade or business that occurred in tax year 1. The remaining IP assets acquired in the tax year 1 acquisition will not be sold. Under the loss disallowance rule, any loss realized on the IP asset sold as part of the sale of business line 1 will not be recognized by C. The loss will be added to the bases of the remaining IP assets, essentially meaning that the basis in excess of the fair market value of the disposed asset is transferred to the remaining assets.

The loss disallowance rule applies in the case of nonrecognition transactions. Thus, in the above illustration, the loss disallowance rule would apply if C transferred the assets of business line 1 to a corporation in a tax-free exchange for stock under Code § 351 and then sold the stock in that corporation.[5]

For the purposes of the loss disallowance rule, members of a controlled group of corporations are treated as a single taxpayer so that no loss is allowed on the disposition of IP by one member of a controlled group of corporations if another member of the controlled group retains other Code § 197 intangible assets that were acquired in the same transaction or series of related transactions as the asset that was disposed of.

If a corporation transfers IP to a shareholder as part of a nonrecognition transaction, such as a distribution that is part of a liquidation of a subsidiary into its parent corporation or a like-kind exchange, the shareholder will step into the shoes of the corporation with respect to the IP. Thus, the shareholder will receive a carryover basis in the IP, and if the IP was amortizable in the hands of the corporation, the shareholder will continue to amortize the IP over the remaining amortization period.

If a corporation distributes IP to a shareholder in a transaction that does not qualify for nonrecognition treatment, such as a dividend in-kind under Code § 301, a stock redemption under Code § 302, or a distribution in complete liquidation under Code § 336, the shareholder's basis in the IP will be its fair market value and the corporation will recognize gain. To the extent of depreciation recapture under Code § 1245, the gain will be taxed as ordinary income. Any additional gain will be treated as capital gain. Note that for the corporation, capital gains and ordinary income are taxed at the same rate. In the event that the corporation has a capital loss carryover from other transactions, the carryover capital losses can reduce capital gains generated from the distribution. Any loss likely will be disallowed to the corporation under the loss disallowance rule discussed above.

Partnerships

Joint development projects, involving two or more parties contributing services, personnel, funding, and other resources, are common arrangements for the development of IP.

The definition of "partnership" in the Code is broad, encompassing a "syndicate, group, pool, joint venture, or other unincorporated organization through or by the means of which any business, financial operation, or venture is carried on, and which is not…a corporation or a trust or estate."[6] Typically, profits and losses must be shared by the participants for there to be a partnership, although the sharing ratio for losses may differ from the sharing ratio for income and gains.

Because the concept of a partnership is broadly defined for tax purposes, if the parties to a joint development do not intend to form a partnership for US Federal tax purposes, they must take care to avoid falling involuntarily within the Code's broad definition of partnership. Their arrangement should be governed by documents that demonstrate that the parties are contracting parties, not partners. For example, the sharing of resources, such as personnel or facilities, should be covered by fees paid by the using contracting party to the contributing contracting party in order to reimburse the latter for use by the former.

Because limited liability companies with more than one member generally are treated as partnerships for US Federal tax purposes, the tax considerations discussed here also apply to Limited Liability Corporations (LLCs).

Acquisitions

Just like a corporation, a partnership can acquire IP in several ways, including

- receiving a contribution of IP from a partner,
- purchasing or licensing the use of IP from another person, or
- creating IP in-house.

The contribution of property by a partner to a partnership is governed by Code § 721, which states that neither the partner nor the partnership generally will recognize gain or loss on the transfer of property in exchange for an interest in the partnership. Unlike Code § 351 (governing the tax-free contribution of property to a corporation, discussed above), Code § 721 does not require the partner to be in "control" of the partnership. Thus, a transfer to a partnership generally is tax-free even if only one person transfers property to the partnership and that person ends up owning a small interest in the partnership after the transfer.

A contribution by a partner to a partnership of property encumbered by debt may result in gain recognition to the contributor because Code § 752(c) generally treats the partnership as assuming the liability. This often decreases the portion of the liability allocated to the contributor. When a partner's liabilities are decreased by reason of a partnership's assumption of a liability, the partner whose debt allocation is reduced is treated as if a cash distribution were made to that partner.[7] Thus, a partner that contributes IP subject to a liability to the partnership may be treated as receiving a cash distribution to the extent of the liability.

Further, debt financing at the level of the partnership often is treated as if the partners borrowed the funds and contributed the proceeds of the borrowing to the partnership. If a partner's share of the debt increases, the partner is treated as contributing cash to the partnership and the outside basis in the partnership increases. If a partner's share of debt decreases, the partner is treated as receiving a distribution of cash from the partnership and the outside basis in the partnership decreases.

The question of whether a partner transferred "property" for the purposes of Code § 721 may arise in the case of a partner that transfers to the partnership less than all of its interest in IP. This transaction is akin to transfer of a right to use IP and is analogous to the grant of a license to the corporation by a controlling shareholder. The tax treatment is governed by the same authorities that are applicable to transfers under Code § 351, discussed above. Similarly, the question of whether a partner may provide services with the transfer of IP and still preserve tax-free treatment under Code § 721 is governed by the same authorities applicable to transfers under Code § 351, discussed above.

As in the case of a corporation, a partnership may acquire IP as a separate asset or as part of a trade or business. In the case of separately acquired IP, the partnership's basis in the IP generally will be the purchase price. In the case of IP acquired as part of a trade or business, the transaction is treated as the purchase of a going concern. The price must be allocated among the assets of the trade or business, including the IP, under the rules of Code § 1060.

In the case of self-created IP, if the partnership is required to capitalize the costs incurred in developing the IP, it will have a basis in the IP attributable to the capitalized costs, which may be amortized. The amortization deductions will pass through to the partners. Alternatively, if the partnership is permitted to deduct all or some of the costs incurred in developing the IP, it will have no basis, or a very low basis, in the IP. The partners will have received a tax benefit at the time the expenditure is deducted on the partnership tax return.

Amortization

Partnerships are subject to the amortization rules for self-created and acquired IP as discussed in "Tax 101: Taxation of Intellectual Property—The Basics."[8] Thus, for example, under the rules of Code § 197, a partnership generally may amortize its basis in a broad list of acquired IP (including, patents, trademarks, trade names, trade secrets and know-how, copyrights, and computer software) if the acquired IP is used in a trade or business or an activity that is carried on for the production of income and was not separately acquired. Code § 197 requires straight-line depreciation over a 15-year period. The rules of Code § 167 must be applied to determine the amortization permitted for a partnership's self-created and separately acquired IP.

Any amortization deduction is determined at the partnership level and is then allocated among the partners under the terms of the partnership agreement.

As with transfers to a corporation, discussed above, in the case of IP contributed to a partnership, one of two situations may arise:

1. A partner may contribute IP that was amortizable in the hands of the partner.
2. A partner may contribute IP that was not amortizable in the hands of the partner, such as certain self-created IP.

In the former case, the transferee partnership generally steps into the place of the transferor partner and, thus, receives a carryover basis, which must be amortized over the remainder of the original amortization period.

As discussed earlier, it is possible for a partner to recognize gain on the contribution of encumbered property to a partnership. However, such gain recognition will not affect the partnership's basis in the contributed property. Thus, unlike with contributions to a corporation, contributions of property to a partnership do not generally result in a bifurcated treatment of the basis of the IP asset for amortization purposes.

In the latter case, the partnership generally will not be permitted to amortize the contributed IP, unless the transferor recognizes gain, which is a very rare occurrence in the partnership context.

Effect of a Code § 754 Election on Amortization

Generally, the sale of a partnership interest in a transaction that produces a gain—often because the fair market value of the partnership's assets exceeds the partnership's basis in those assets—does not trigger any adjustment in the basis of the partnership in its assets. The basis of the partnership in its assets is referred to often as the partnership's "inside basis" in the assets. The partner's basis in the partnership interest is referred to often as the partner's outside basis in the partnership. Thus, for example, if X acquires an interest in partnership P, at its fair market value, and P holds only one asset with a fair market value that is considerably greater than P's adjusted basis in the asset, the partnership's inside basis in the asset will not be adjusted upward to reflect the fact that X paid fair market value for the interest in P. If partnership P then sells the appreciated asset, X will be allocated his share of the built-in gain from the sale of the asset. X's share of the gain does not take into account the fact that he recently paid fair market value for his interest in P.

To alleviate the unfairness of the foregoing result, a partnership may make an election under Code § 754 to step up the basis in the partnership's assets as they relate to the transferee partner. The basis adjustment is authorized by Code § 743(b).[9] Again, only the transferee partner benefits from the election. In the above example, if partnership P makes a Code § 754 election in connection with X's acquisition of a partnership interest in partnership P, X—and only X—would be entitled to benefit from an increase in the inside basis of partnership P's asset. If partnership P then sells the asset, X's share of any built-in gain would be reduced to reflect the adjusted basis that resulted from his purchase of the interest in P.

Similarly, a Code § 754 election allows a partnership to elect to adjust the basis under Code § 734(b) in partnership property retained after it makes a distribution of money or property to a partner if as a result of a distribution, the distributee recognizes any gain or loss or takes a basis different from the partnership's basis in the case of a property distribution.[10] So, for example, assume a partnership having appreciated property and cash distributes cash to only one partner and as a result, that partner recognizes gain because the cash exceeds the outside basis in the partnership. If a Code § 754 election is in effect, Code § 734(b) allows the partnership to increase its basis in property retained by the partnership. This prevents a double level of possible gain recognition among the partners—once at the time of the distribution that results in a gain to a partner and a second time when appreciated assets are subsequently sold. On the other hand, if a partnership makes a liquidating distribution to a partner that terminates the entire interest in the partnership, and the amount distributed consists of cash, unrealized receivables, and inventory worth in total less than the outside basis of the retiring partner's interest in the partnership, the retiring partner realizes a loss. If a Code § 754 election is in effect, Code § 734(b) requires the partnership to reduce its basis in property retained by the partnership. This prevents a double level of possible loss recognition among the partners—once at the time of the liquidating distribution that results in a loss to the retiring partner and a second time when appreciated assets are subsequently sold.

A Code § 754 election may result in amortization benefits for IP amortizable under Code § 197 to the extent a taxpayer (a partner or the partnership) obtains an increased adjusted basis in such IP. An example of a contribution of IP that may result in gain involves transfers to partnerships with related foreign partners as provided in temporary regulations promulgated during the final days of the Obama Administration purporting to limit the scope of nonrecognition treatment when appreciated property is transferred to a partnership having non-US persons as partners in certain circumstances.[11] For those transfers, immediate gain recognition is mandated by the temporary regulations. Where gain must be recognized in connection with a transfer to a partnership, a bifurcated approach is followed: the portion of the basis that represents the upward basis adjustment is amortized over a new 15-year amortization period and the remaining basis will continue to be amortized under the remaining amortization period.

Effect of a Constructive Termination on Amortization

If 50 percent or more of the interests in a partnership are sold within a 12-month period, the partnership is deemed to have terminated.[12] The constructive termination is treated as a transfer of all of the assets of the terminated partnership to a new partnership in exchange for interests in the new partnership, immediately followed by the distribution of the interests in the new partnership to the partners in proportion to their interests in the terminated partnership.

Under a constructive termination, the new partnership's basis in an asset amortizable under Code § 197 generally will be the same as the terminated partnership's basis in the asset. Thus, amortization will not be impacted by the constructive termination. However, if a Code § 754 election is in effect, adjustments to basis may be required. In such cases, the bifurcated approach discussed above must be followed.

Deduction for R&D Expenses

Under Code § 162, a taxpayer may deduct the ordinary and necessary expenses incurred in carrying on a trade or business. In the case of a start-up business, such as a partnership formed to develop new IP, Code § 162 will not apply if the business is in the development phase and not yet "carrying on" a trade or business.

In contrast, Code § 174(a)(1) permits a taxpayer to deduct research or experimental expenditures paid or incurred "in connection with" its trade or business, which has been interpreted to mean that research or experimental expenditures may be deducted during the phase in which a start-up business is preparing to go into business but is not yet in business.[13]

Notwithstanding the above, the taxpayer need never be involved in a trade or business. So, a partnership that is set up to develop a new product and which then sells the IP without reducing it to commercial value by using it in a trade or business likely will not be allowed to take the Code § 174 research and development (R&D) deduction.[14] Similarly, a partnership that has no plans or ability to market or exploit any products that it might develop likely will not be allowed the Code § 174 R&D deduction.[15]

Dispositions

Disposition of IP by a Partnership

In a sale of amortizable IP to a third party, the main issues to consider are whether any gain will be characterized as ordinary income under the Code § 1245 recapture rules and whether the remaining gain is capital gain, or any loss is capital loss, under Code § 1231. If the IP is not amortizable, the gain or loss may be capital gain or loss under Code § 1221.

In a sale of amortizable IP to a partner, any gain in excess of the Code § 1245 recapture amount will be characterized as ordinary income under Code § 1239 if the partner holds a greater than 50 percent interest in the partnership. If Code § 1239 does not apply, the typical characterization rules, discussed above in the context of unrelated party sales, apply.

Amounts realized in excess of the Code § 1245 recapture amount may be afforded long-term capital gains treatment.

Further, the loss disallowance rule of Code § 197(f), discussed above, also applies to partnerships. Thus, no immediate loss is recognized if a group of Code § 197 intangibles is acquired and less than all such intangibles are sold. The amount of the loss increases the basis in the retained Code § 197 intangibles.

In the case of distributions of IP to partners, special basis rules may apply to intangible assets amortizable under Code § 197 depending on whether the distribution is a non-liquidating or a liquidating distribution. In the case of a non-liquidating distribution of such IP, under Code § 731, the distributing partnership generally does not recognize gain or loss resulting from the distribution, and this nonrecognition treatment means that the distributee partner steps into the shoes of the distributing partnership with respect to the adjusted basis and amortization period of the IP.

In the case of a liquidating distribution, the distributed property will have a basis equal to the partner's outside basis in his partnership interest. If more than one asset is distributed, the partner's outside basis must be allocated among the assets received in the liquidating distribution. If the allocated basis is less than the partnership's basis, the carryover approach, discussed above in the case of non-liquidating distributions, applies. If the allocated basis is more than the partnership's basis, a bifurcated approach must be taken under which the distributee partner will amortize the increase in basis over a new 15-year amortization period and the remaining basis will continue to be amortized in the same manner as it was in the hands of the partnership.

In the case of distributed IP that is not amortizable in the hands of the distributing partnership, the distribution to the distributee partner, by itself, generally does not cause the IP to be amortizable in the hands of the distributee partner.

Disposition of an Interest in a Partnership that Owns IP

Under Code § 741, gain or loss from the sale of an interest in a partnership generally is treated as derived from the sale of a capital asset, regardless of the underlying assets held by the partnership. The exception to this rule arises when the partnership holds assets described in Code § 751, specifically: unrealized receivables[16] and inventory items.[17] Code § 751 assets are sometimes referred to as "hot assets." If part of the sales proceeds from the sale of a partnership interest is attributable to a hot asset, that amount is treated as ordinary income. The rule prevents partners from converting ordinary income into capital gain through a sale of a partnership interest.[18]

In the IP context, the term "unrealized receivables" includes franchises, trademarks, and trade names as described in Code § 1253(a).[19] Under that provision, a transfer of a franchise, trademark, or trade name is not treated as sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.[20] This provision typically applies to businesses that sell franchises to customers in the ordinary course of business. In a franchise operation, the franchisee is granted the right to use trademarks and trade names, along with specified know-how, within a specified geographic area on an exclusive or non-exclusive basis in connection with the operation of a business on a standardized basis so that the quality and appearance of the business looks alike throughout the territory where franchisees operate. In order to maintain quality and appearance throughout the territory, the franchisor retains certain rights after the "sale" of the franchise. Code § 1253 was enacted to prevent franchisors from claiming favorable capital gains tax treatment each time franchise rights were sold to a franchisee. It achieves this by denying capital gains treatment when the franchisor retains significant power, right, or a continuing interest in the rights that are sold, since retention of such powers is crucial in maintaining uniformity across the territory.

Code § 1253(b)(2) defines "significant power, right or continuing interest" as including a right to

- disapprove any part of an assignment of such interest;
- terminate the interest at will;
- prescribe standards of quality for products used or sold, or services furnished, and of the equipment and facilities used to promote such products or services;
- require that the transferee exclusively advertise or sell products and/or services of the transferor;
- require that the transferee purchase substantially all operating equipment and supplies from the transferor; and
- require payments that are dependent on the productivity, use, or disposition of the transferred interest.

The regulations under Code § 751 are intended to prevent Code § 1253 from being circumvented by creating franchising partnerships that ultimately could be sold in transactions producing capital gains in accordance with Code § 741. To achieve that goal, Treasury Regulation § 1.751-1(c)(4)(viii) states that hot assets include the "potential gain" that would arise from the sale of franchises and related trademarks and trade names and would be treated as ordinary income under Code § 1253(a).[21]

As discussed above, if a partnership makes an election under Code § 754, it may adjust the basis of the partnership's assets under Code § 734(b) (relating to adjustments of bases to the assets retained by the partnership after a distribution of property to a partner) and Code § 743(b) (relating to adjustments of bases of partnership properties for a partner acquiring a partnership interest). If the partnership holds IP assets, any increase in the bases of these assets as a result of the basis adjustments may provide additional amortization benefits under Code § 197.

Similarly, if the disposition of a partnership interest results in a constructive termination of the partnership (as discussed above) and a Code § 754 election is in effect, adjustments to basis may be required, which may result in additional amortization benefits under Code § 197.

Conclusion

IP owned or utilized as part of a business, typically is held though a corporation or partnership. As demonstrated above, significant tax issues arise during the life cycle of the IP: when IP is created, acquired, used, licensed, sold, and in the case of a partnership or LLC, the interest in the flow-through entity owning the IP is sold. Proper planning is important at each step in the life cycle. Mistakes in tax planning can be expensive.

1. Rev. Rul. 69-156, 1969-1 C.B. 101.
2. E.I. Dupont de Nemours v. U.S., 471 F.2d 1211 (Ct. Cl. 1973).
3. Field Service Advice 1998-481.
4. Rev. Rul. 64-56, 1964-1 C.B. 133.
5. Treas. Reg. § 1.197-2(g)(1)(i)(C).
6. I.R.C. § 761(a).
7. I.R.C. § 752(b).
8. Stanley C. Ruchelman and Elizabeth V. Zanet, "Tax 101: Taxation of Intellectual Property—The Basics," Insights 5 (2017), *http://www.ruchelaw.com/publications/tax-101-taxation-of-intellectual-property-the-basics*
9. Code § 743 provides rules for basis adjustment to the partner's adjusted basis in the partnership property when a Code § 754 election is in effect or there is a substantial built-in loss (*i.e.*, greater than $250,000) with respect to a partnership's adjusted basis in the partnership property. In the case of a substantial built-in loss, the basis adjustment is mandatory (*i.e.*, no Code § 754 election is required). Further, though in the above example, the basis adjustment was advantageous to the taxpayer, the required adjustment may be disadvantageous (such as in the case of net built-in loss) because it may require the partner to decrease his adjusted basis in the partnership property partnership property, thus decreasing or eliminating the partner's potential loss on a sale of the partnership property. Further, in such a case, no amortization benefit will be obtained in the case of amortizable IP.
10. Code § 734 provides rules for basis adjustment to the partnership's retained property when a Code § 754 election is in effect or, in the case of a substantial built-in loss, when a mandatory basis adjustment is required.
11. Treas. Reg. §§ 1.721(c)-2T, 1.721(c)-3T.
12. I.R.C. § 708.
13. Snow v. Commr., 416 U.S. 500 (1974) (limited partner in start-up partnership formed to develop new product, but which had no income, was permitted to deduct his share of net operating loss attributable to the R&D deduction under Code § 174).
14. Harold J. Green, 83 T.C. 667 (1984).
15. Harris v. Commr., T.C. Memo 1990-80, 58 T.C.M. 1441.
16. That is, rights to income not previously included under the method of accounting used by the partnership, such as goods delivered or to be delivered or services rendered or to be rendered, to the extent that proceeds therefrom would be treated as a sale or exchange of property other than a capital asset.
17. That is, an inventory item with fair market value in excess of 120 percent of partnership's adjusted basis in such item.
18. I.R.C. § 751.
19. I.R.C. § 751(c) (flush language).
20. I.R.C. § 1253(a).
21. Treas. Reg. § 1.751-1(c)(4)(viii).