

INTELLECTUAL PROPERTY TRANSACTIONS –

TAX ISSUES

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May 3, 2005

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INTELLECTUAL PROPERTY TRANSACTIONS – TAX ISSUES

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1. EXPENSES OF CREATING WORKS SUBJECT TO COPYRIGHT

1.1. Free Lance Authors, Photographers, And Artists

- ◆ Pre-1987 capitalization rules apply - expenses generally deductible under and not capitalized¹

1.2. Other Creators

- ◆ Can elect to write off over three years²

1.3. Works for Hire

- ◆ Payments to creators to create “works for hire” are ordinary income to the creators.
- ◆ The owner of the work created “for hire” deducts the payments as trade or business expenses or investment expenses, if the payments are not capitalized under Section 263A.

1.4. Publishers

- ◆ Subject to Section 263A capitalization rules.

1.5. Amortization of Capitalized Expenses

- ◆ Safe harbor for amortizing created intangibles without readily ascertainable useful lives – 15 years.³ Does not apply to

¹ I.R.C. § 263A(h).

² Notice 88-62, 1988-1 C.B. 548.

³ Treas. Reg. § 1.167(a)-3.

acquired intangibles. Does not overrule other specific amortization rules.

Note: These are general rules that are subject to many exceptions.

2. LICENSING WORKS SUBJECT TO COPYRIGHT

2.1. General rule

- ◆ Non-exclusive licenses or exclusive licenses for less than the full term of the copyright are treated as licenses (not sales) for tax purposes.
- ◆ Exclusive licenses for the full term of the copyright are treated as sales (not licenses) for tax purposes.⁴

2.2. Nonexclusive Licenses:

- ◆ Royalty payments are ordinary income to the licensor.⁵
- ◆ Royalty payments are deductible by the licensee (as trade or business expenses or investment expenses), unless they must be capitalized.⁶

2.3. Exclusive Licenses:

- ◆ Excluded from the definition of a capital asset – and from the definition of Section 1231 property: inventory and “a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property.”⁷
- ◆ This taint applies to those who take the property in carryover basis transactions.

⁴ Rev. Rul. 60-226, 1960-1 C.B. 26.

⁵ I.R.C. § 61(a)(6).

⁶ If the copyright is used to create another asset with a useful life of more than one year, the payments must be capitalized. If the payments are made to create inventory items, the payments must be capitalized under Section 263A. Treas. Reg. §. 1.263A-1.

⁷ I.R.C. §§ 1221(a)(1), (3)(A), 1231(b)(1).

- ◆ The assignment of income doctrine applies to avoid “deflecting” income from the creator to others.
- ◆ Third parties who do not hold the rights as inventory can have capital gain on the disposition of copyrights.
- ◆ A license in a particular medium is a sale if it is exclusive and for the duration of the copyright.⁸
- ◆ A license for a particular country is a sale if it is exclusive and for the duration of the copyright.
- ◆ If the transfer is a sale, the buyer/licensee might be allowed to amortize the cost:
 - ⇒ For lump sum payments for movie or television films, the income forecast method is used.
 - ⇒ For lump sum payments for a book manuscript or other medium of expression, either the income forecast or straight-line method may be used.
 - ⇒ If the asset has no ascertainable useful life (such as a Picasso painting), no depreciation or amortization deduction is allowed.
 - ⇒ For contingent payments, the royalties will be used as a measure of the useful life, in effect making the royalty payments deductible are depreciation deductions.
 - ⇒ However, if the copyright is acquired in the purchase of a business, the asset is a “Section 197 intangible” (which includes copyrights⁹), the four rules above will not apply, and the copyright is amortized over 15 years.

⁸ Rev. Rul. 60-226, *supra*.

⁹ I.R.C. § 197(d)(1)(C)(iii).

3. **TRADEMARKS (AND FRANCHISES AND TRADE NAMES)**

3.1. **Costs to Create, Register, Police and Defend the Mark**

- ◆ Capitalized.
 - ⇒ Exception (sort of) – advertising costs build the value of the mark, but generally they are currently deductible.
 - ⇒ The deductibility of expenses to challenge others' marks as confusingly similar has been the subject of litigation.
- ◆ The mark has no readily ascertainable useful life, so the capitalized costs are not subject to depreciation or amortization deductions.
- ◆ Section 174 (research or experimental expenditures) does not permit a current deduction.

3.2. **General Rule for Transfers if Marks – Section 1253**

- ◆ Does the transferor retain any significant power, right, or continuing interest?
 - ⇒ If so, it's a license.
 - ⇒ If not, it's a sale.

3.3. **Payments to Transferors/Licensors/Sellers**

- ◆ Lump sum payments are subject to general tax principles.
- ◆ The installment method can apply to non-contingent payments that are not made in a lump sum.
- ◆ If the payments are contingent on use, the payments are not from the sale of a capital asset.

⇒ It is not clear that the transferor can apply its basis in the asset transferred.¹⁰

3.4. **Payments by Transferees/Licensees/Buyers**

- ◆ Contingent payments paid at least annually pursuant to a fixed formula or in equal payments are currently deductible.¹¹
- ◆ Other payment are capitalized and amortized over 15 years.¹²

4. **PATENTS – A DIFFERENT ANIMAL TAX-WISE**

4.1. **Long-term capital gain for the transferor under Section 1235**

- ◆ A transfer of all of substantially all of the rights in a *patent* will result in long-term capital gain (or, probably, loss) to the transferor, regardless of the method of payment or the transferor's holding period.
- ◆ This applies whether the transferor is the creator or a purchaser
 - ⇒ It does not apply if the transferor is the employer of – or is related to – the creator.
 - ⇒ C and S corporations cannot be transferors for this purpose.
 - ⇒ The individual members of a partnership , LLC or the individual beneficiaries of a trust can be transferors.
 - They must acquire their interest before the invention is reduced to practice.¹³

¹⁰ The statute characterizes the “Amounts received or accrued on account of a transfer” and not the “gain.” I.R.C. § 1253(c). Regs were proposed and withdrawn.

¹¹ I.R.C. § 1253(d)(1)(A).

¹² I.R.C. §§ 197(a), (d)1)(F), 1253(d)(2).

¹³ I.R.C. § 1235(b)(2).

- ◆ It applies to a professional inventor.
- ◆ Imputed interest rules do not apply to the “sale.”
- ◆ Improvement patents qualify.
- ◆ A transfer of an undivided interest can also qualify.
- ◆ This rule might also apply to an unpatented invention that *could* be patented.

4.2. **Employees**

- ◆ Employees who are paid to create inventions for their employers cannot use this provision to turn compensation income into long-term capital gain.¹⁴
- ◆ If the employee is not paid to invent, but creates a patentable invention on his employer’s time, the employer gets “shop rights” to use the invention. The employer’s retention of these rights will not prevent the employee from transferring substantially all for the rights in the patent and qualifying under Section 1235.

4.3. **“Substantially all” of the rights**

- ◆ A “field of use” license will not transfer substantially all of the rights
- ◆ The geographic scope may be limited to the entire country, but if it is limited to a smaller area, it will not transfer substantially all of the rights

4.4. **Patent Transfers Outside of Section 1235**

- ◆ For professional inventors, an invention is probably stock in trade and not a capital asset. As stock in trade, it will not qualify as Section 1231 property.

¹⁴ Treas. Reg. § 1.1235-1(c)(2).

- ◆ General tax law principles identifying sale apply outside Section 1235.
- ◆ Contingent or installment payments will not themselves prevent the transaction from resulting in long-term capital gain.

4.5. **Tax consequences for the licensee**

- ◆ A patent always has a readily ascertainable useful life.
- ◆ If payment is contingent on use, depreciation deductions are allowed as royalties are paid.
- ◆ If the payment is a fixed amount, depreciation deductions are allowed over the remaining useful life of the patent.¹⁵

5. **KNOW HOW**

5.1. **Hard to define**

- ◆ Know how is property, but it has been hard for the courts and the IRS to define.
- ◆ Generally, the IRS view know how as secret processes.
- ◆ Know how vs. trade secret?

5.2. **Capital asset or Section 1231 property**

- ◆ Also can be transferred to a corporation tax-free for stock under Section 351.

5.3. **Transfers of know how**

- ◆ General tax principles apply
- ◆ Section 1235 concepts might apply, to the extent that they embody general tax law.

¹⁵ An exception applies if the patent is acquired in connection with the purchase of a business. In that case, the cost of the patent is amortized over 15 years under Section 197, apparently without regard to the possibly shorter remaining life of the patent.

- ⇒ Substantially all rights
- ⇒ Ordinary income for license royalties vs. capital or Section 1231 gain for sales
- ⇒ Section 197 can apply to the buyer of a business who also acquires know how.
- ⇒ For expenses to develop know how, Section 174 can permit a current deduction.

6. COMPUTER SOFTWARE

6.1. Licensor

- ◆ Royalties from a *non-exclusive* license are ordinary income.
 - ⇒ Royalties can be personal holding company income for closely-held C corporation., but copyright royalties will *not* count as PHC income if
 - They are more than half of the corporation’s ordinary income and the corporation has very little other passive income; or
 - If they are “active business computer software royalties.”¹⁶ These royalties will be “passive income” for purposes of the S corporation “excess passive income” rules¹⁷.
- ◆ Royalties from an *exclusive* license should be treated as sale proceeds. Typically, this license would include the right to change the code and to modify the operation and the look of the software.
 - ⇒ The first step is to analyze whether copyright law applies and, if so, the characterization under those rules.

¹⁶ I.R.C. § 543(d)(1).

¹⁷ Treas. Reg. § 1.1362-2(c)(5).

- Copyright law applies if the transferred right is the right to copy and distribute to the public.

⇒ Capital gain treatment should be available if the software is not inventory or subject to copyright (for example, if it is part of a patented process or, possibly, a trade secret).

6.2. Licensee

- ◆ Royalties for a *non-exclusive* license should be currently deductible as trader or business expenses or investment expenses.

⇒ If the software is used to create an asset with a useful life of more than one year, the royalty payments must be capitalized.

- ◆ Royalties from an *exclusive* license would be capitalized and amortized.

[End of outline.]