CHAPTER 1

Introduction

Chapter Contents

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§ 1.01 In General

Effective tax planning requires a tax counselor to simultaneously remember the past, know the present and anticipate the future. This is nowhere more true than in the taxation of capital gains and losses arising from multiyear arrangements for the exploitation of technology. Proper planning at the outset of a proposed transfer lays the groundwork for potential tax reductions in later years. A misstep can almost never be eradicated by subsequent acts.

Traditionally, gains from the sale or exchange of capital assets held long-term have been subject to a favorable tax rate that is much lower than the rate applied to other forms of income. The rate differential has varied over the years and was eliminated for a short period in the mid-1980s. The long term holding period has also varied, ranging during the mid-1990s from six to eighteen months. In the late 1990s, the asset holding period again become "more than one year," with a 20% tax savings caused by the rate differential. It is this savings that makes it economically desirable to structure transfer of intellectual property in a manner that will achieve capital gains taxation. That is the topic of this treatise.

For taxable years beginning after 1981 and before 1986, a noncorporate taxpayer's maximum tax rate on ordinary income was 50 percent,[1]

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[1] Former I.R.C. § 1(a).

while the maximum tax rate on long-term capital gains was only 20 percent as a result of the deduction from gross income allowed for a portion of such gains.[2] Furthermore, capital gains could be offset by capital losses and up to $3000 of ordinary income could be reduced by capital losses (however long-term capital losses reduced ordinary income on a 2 to 1 basis).[3] For taxable years beginning after 1986, the special deduction for long-term capital gains is repealed,[4] although the capital gains taxing structure is retained in the Internal Revenue Code "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase"[5] and the need to identify capital gains subject to offset by capital losses continues because long-term and short-term capital losses reduce ordinary income (up to a maximum of $3,000 per year) on a 1 to 1 basis.[6]

After 1993, net capital gains realized by individuals are taxed at a maximum rate of 28%[7] although rates on ordinary income can be as high as 39.6%.[8] Thus, the rate advantage for capital gains returns to the Tax Code albeit currently in an attenuated form, i.e., 11.6%.

Corporate taxpayers face a similar rate differential on capital gains for taxable years beginning before 1986. For those years, long-term capital gains are taxed at a lower alternative rate (28% for taxable years ending after 1978).[9] For taxable years beginning after 1986, the alternative rate results in the imposition of the same rates as on ordinary income so long as those rates do not exceed 35%.[10] For taxable years beginning in 1986 and ending in 1987, a blended rate is provided.[11] Furthermore, in all taxable years, corporate taxpayers may offset capital losses only against capital gains and are allowed no reduction in ordinary income based on capital losses.[12]

The Taxpayer Relief Act of 1997[13] generally reduced the long-term capital gains tax rate for noncorporate taxpayers from 28% to

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[2] Former I.R.C. § 1202(a). The various rationales advanced in support of the tax rate differential favoring capital gains are presented in Surrey, *et al., Federal Income Taxation* (1986. 1987 Supplement at 27-28).

[3] Former I.R.C. § 1211(b).

[4] Tax Reform Act of 1986 § 301(a), repealing I.R.C. § 1202.

[5] Report 99-841, Conference Report to Accompany H.R. 3838, 99th Cong., 2d Sess., II-106 (non-corporate taxpayers), II-107 (corporate taxpayers).

[6] I.R.C. § 1211(b); 26 U.S.C. § 1211(b).

[7] I.R.C. § 1(h)(1)(E); 26 U.S.C. § 1(h)(1)(E).

[8] I.R.C. § 1(a)-(e); 26 U.S.C. § 1(a)-(e).

[9] Former I.R.C. § 1201(a).

[10] I.R.C. § 1201(a); 26 U.S.C. § 1201(a).

[11] Tax Reform Act of 1986 § 311(d).

[12] I.R.C. § 1211(a); 26 U.S.C. § 1211(a).

[13] P.L. 104-34, 111 Stat. 788 (1997).

20%.[14] In passing the Act, Congress unfortunately greatly increased the complexity of the capital gains rate structure by introducing three rate groups of 28%, 20% and 10%. The application of each rate is dependent on the type of asset and its holding period.[15] Gains qualifying for special treatment under the safe harbor capital gains provisions fell through the cracks of the 1997 Act but were initially preserved in the 20% rate group through a concession by the Internal Revenue Service[16] and subsequently by statutory amendment.[17] The 1998 Internal Revenue Service Restructuring and Reform Act somewhat relieves the complexity of the 1997 enactment by reducing the long-term holding period for all three capital gains rate groups to "more than one year."[18]

The Jobs & Growth Tax Relief Reconciliation Act of 2003 further reduced the 20- and 10-percent rates on adjusted net capital gains to 15 and 5 percent, respectively, effective in taxable years ending on or after May 6, 2003, and beginning before January 1, 2009. These lower rates thus applied to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003.[19]

Proper tax planning in the preparation of "licensing agreements"[20] may result in the proceeds of the license being taxed at favorable capital

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[14] I.R.C. § 1(h); 26 U.S.C. § 1(h), as amended in 1997. Since the maximum noncorporate tax rate is 39.6%, the precise rate differential favoring capital gains is 19.6%.

[15] See generally, Annotation, "Net Capital Gain Tax Rate," CCH Std. Fed. Tax Rpts. ¶ 3185, noting that, with subcategories and transition rules, there were eight different capital gains rates.

[16] IRS Notice 97-59, 1997-45 I.R.B. 7, 8 (Nov. 10, 1997).

[17] P.L. 105-206, § 6005(d)(4) 112 Stat. 804 (1998). The amendment includes transfers taken into account after May 6, 1997 and before January 1, 1998. P.L. 105-206, § 6024 112 Stat. 826 (1998).

In 2010, the tax rate on long term capital gains and dividends was 0% for taxpayers below the 25% tax bracket, and 15% for those above except for certain special cases. The rates were scheduled to return to 10% and 20% rates respectively in 2011, but the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," Pub. L. No. 111-312, 124 Stat. 3296 (2010) extended the lower rates for another two years, through 2012. In early 2013, Congress enacted the American Taxpayer Relief Act, P.L. 112-240, 126 Stat. 2313 (Jan. 2, 2013), pursuant to which the top rate for capital gains returned to 20% for certain high income individuals," i.e., those taxpayers whose income exceeds the thresholds for the 39.6% rate ($400,000 for single filers, $450,000 for joint filers, and $425,000 for heads of households). All other taxpayers will continue to be subject to a maximum 15% capital gains rate, and a 0% rate will continue to apply to capital gains for those whose income is below the top of the 15% income tax bracket, which is projected for 2013 to be $72,500 for joint filers and $36,250 for single filers.

[18] Conference Committee Report on H.R. 2676, S. Rep. No. 105-174, 105th Cong., 1st Sess. 161 (1998).

[19] P.L. 108-27, §§ 301, 303, 117 Stat. 752 (2003). Under the Act's sunset provision, the amendment does not apply to tax years after December 31, 2008.

[20] Thus, in patent law terminology, an "assignment" is a sale while a "license" is not a sale but merely a rental of the use of the patent.

gains rates. Since the late 1970's, the tax law governing license agreements for intellectual property has become settled. Since most license agreements are prepared by intellectual property specialists rather than by tax practitioners, a need exists to carefully plot a safe channel through the "rocks and shoals" of the tax law. Through careful planning and draftsmanship it is possible to guarantee sale treatment, and the resulting taxation at capital gains rates, for virtually any transaction. Without planning, however, a neglected word or a seemingly innocuous provision may prove fatal to efforts aimed at achieving the desired tax result. In part, this trap for the unwary is due to overly technical requirements based on archaic case law,[21] a failure to clearly identify the subject "property," and poorly reasoned opinions which ignore precedent and basic concepts. further complications arise from the statutory overlap in this area. Capital gains treatment for patent transfers may be obtained under I.R.C. Sections 1221 and 1222,[22] under Section 1231,[23] and under Section 1235.[24] This treatise will focus on the application of these provisions to transfers of technological forms of intellectual property, specifically patent rights, trade secrets, and know-how,[25] to transfers of commercial forms of intellectual property, specifically trademarks and trade names,[26]

[21] Much of the case law concerning the requirements for a "sale" traces its origin to the Supreme Court decision in Waterman v. McKenzie, 138 U.S. 252, 11 S.Ct. 334, 34 L.Ed. 923 (1891), a nontax case dealing with the intricacies of common law pleading. The ghost of *Waterman* continues to haunt sellers of patents even though numerous cases have recognized its irrelevance for tax purposes. See § 5.02 *infra*.

[22] I.R.C. §§ 1221, 1222; 26 U.S.C. §§ 1221, 1222. These sections (formerly Int. Rev. Code of 1939, ch. 289, § 117(a)(1)-(9), 53 Stat. 50) provide for capital gains treatment on the sale or exchange of a capital asset.

[23] I.R.C. § 1231; 26 U.S.C. § 1231. This section (formerly Int. Rev. code of 1939 § 117(j), Revenue Act of 1942, ch. 619, § 151, 56 Stat. 846) provides, in conjunction with § 1222, for long-term capital gains treatment on the sale of property used in a trade or business under certain circumstances. Hereinafter, § 1231 and §§ 1221 / 1222 will be referred to as "regular capital gains" provisions.

[24] I.R.C. § 1235; 26 U.S.C. § 1235. This section (analogous to Internal Revenue Code of 1939 § 117(q), Pub. L. No. 629, ch. 464, § 1, 70 Stat. 404 (1956), which was enacted retroactively two years *after* the 1954 Code), provides a safe harbor that guarantees long-term capital gains treatment to the proceeds of certain qualifying transfers of patent rights. It applies only to patent rights, and only to certain transfers by specified persons. It covers a subclass of transactions generally covered by Sections 1221 and 1222. Hereinafter, Section 1235 will be referred to as the "safe harbor capital gains" provision.

[25] Unlike patents, trade secrets and know-how are eligible for capital gains treatment *only* under the regular capital gains provisions of Sections 1221, 1222, and 1231. Hereafter, use of the term "patent rights" will include trade secrets and know-how unless otherwise specified. The tax rules applicable to such transfers are, in general, identical to those for the transfer of patent rights. Kaczmarek v. Commissioner, 43 T.C.M. 501, 504-505 (1982). See Chapter 8 *infra*.

[26] Trademarks and trade names are eligible for capital gains treatment *only* under the regular capital gains provisions and *only* when Section 1253 does not apply. The rules applicable to such transfers are generally identical to those for the transfer of patent rights. Pickren v. United States, 378 F.2d 595, 599 (5th Cir. 1967). The term "patent rights" as used in this text includes trademarks and trade names unless otherwise specified. See Chapter 8A *infra*.

and to transfers of artistic forms of intellectual property, specifically copyrights.[27]

Much of the confusion in the cases dealing with the tax consequences of intellectual property transfers appears to be the result of inadequate research. Court opinions are rife with conclusions which ignore, or do not rationally distinguish, numerous contrary decisions,[28] citations to older cases for points that have been overruled by the intervening development of the law,[29] and citations to cases decided under other subchapters of the Code which are based on policies peculiar to those subchapters.[30] There has been tremendous development in the tax rules governing intellectual property transfers, both through cases and rulings, and through statutory amendments. Citation to older cases without proper consideration of those changes must be avoided. If counsel and the courts followed this one simple rule, both taxpayers and the government would benefit.

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[27] The use of the term "copyrights" in this text includes a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property. Such property is only eligible for capital gains treatment under the regular capital gains provisions and only when Section 122(3) does not apply. Otherwise, the tax rules applicable to such transfers are the same as those applied to the transfer of patent rights. See Chapter 8B *infra*. The term "patent rights" as used in this text includes copyrights unless otherwise specified.

[28] See, e.g., Chapter 7 *infra*.

[29] For example, the case of Tolwinsky v. Commissioner, 86 T.C. 1009, 1043 (1986) cites to Cory v. Commissioner, 23 T.C. 775 (1955), *aff'd on other grounds* 230 F.2d 941, 944 (2d Cir. 1956), for the proposition that "[n]o sale occurs if the transferor retains proprietary rights" in the transferred property. The "proprietary" right which the court thought significant in *Cory* was the receipt of contingent payments, a matter which has long been determined to be an insubstantial right which does not prevent a sale. See 5.05 *infra*. There are many better citations which could have been used to make this point. See § 5.03 *supra*. Another example is the "resurrection" of the discredited *Waterman* test in Green v. Commissioner, 83 T.C. 667 (1984). See §§ 5.02 and 5.03 *supra*.

[30] Cases involving application of the source rules of Subchapter N (foreign tax) are not precedent in cases applying regular capital gains provisions, even where the meaning of the same word (e.g., "royalties") is at issued. See the misapplications going both ways in Cory v. Commissioner, 230 F.2d 941, 943 (2d Cir. 1956), and Rohmer v. Commissioner, 153 F.2d 61, 65 (2d Cir. 1946).

§ 1.02 Inventor's Needs

Inventors frequently find it beneficial to allow others to commercially exploit their inventions, thereby taking advantage of the capital resources and marketing skills of others. This procedure is especially desirable when the invention constitutes only a small portion of the total commercial product notwithstanding the singular importance or value of the particular invention. By renting (licensing) or selling (assigning) his invention to another more capable of maximizing the invention's income-producing potential, the inventor may be able to achieve an after-tax return from the sale of a patent in excess of that which would be attainable through self-exploitation.[1]

The inventor is often at a disadvantage in marketing his creation since its value is usually speculative prior to commercial sales. For a fair price to be agreed upon, a mechanism must be devised which will balance the inventor's certainty that his invention is revolutionary with the developer's skepticism regarding ultimate acceptance in the marketplace. Thus, some form of contingent payment, varying with the productivity, use, or disposition of products embodying the invention, is frequently used.[2] Under such an arrangement, the inability of the parties to assess the true value of the invention prior to production and merchandising does not prevent an immediate sale. The expectations of both parties are protected by this arrangement, but the inventor must rely on the good faith and reasonable business efforts of the buyer. Thus, the transferor-inventor must maintain some control over the property in order to ensure that the transferee puts forth his best efforts and that the maximum purchase price is obtained.[3] The inventor's need to employ royalty-type pay-

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[1] See generally: Bristor, "Intellectual Property as Transferable Property for Purposes of Section 351," 780 PLI/Tax 957 (Oct.-Nov. 2007); Breier, "Special Provision for Inventors Insures Capital Gains But Requires Strict Compliance," 7 Tax'n for Acct. 226 (1971); Note, "Capital Gains Treatment of Patent Transfers," 17 Case W. Res. L. Rev. 844 (1966). See also, Lamar v. Granger, 99 F. Supp. 17 (W.D. Pa. 1951), in which the district court stated "an individual of inventive mind rarely has the ability, financial or otherwise, to produce and market his inventions. He has to depend upon others. . . ."

[2] In Kronner v. United States, 110 F. Supp. 730, 734 (Ct. Cl. 1953), the court noted that payment of a royalty dependent upon the productivity, use, or disposition of the invention, is the *only* equitable method by which a fair consideration can be obtained. Calculating purchase price installment payments with reference to an invention's productivity, however, is similar to the calculation of rental value for mere use. This surface similarity is the root cause of much of the Commissioner's antipathy to capital gains treatment of patent sales.

[3] The district court in Lamar v. Granger, 99 F. Supp. 17 (W.D. Pa. 1951), stated:

> "[The inventor must] depend upon others and it is a means of self-protection to include [termination] clauses; otherwise he is at the mercy of the assignee. It is the only control he has. The equity power of a court could not be available to compel specific performance. By the very nature of the relationship such clauses are included

ments[4] and to retain some rights in the property has caused the courts great difficulty in determining whether there has been a sale or merely a rental of the patent rights. The agreement must be closely examined to determine whether enough rights in the intellectual property have been transferred to classify the disposition as a "sale."

An inventor may, of course, simply sell his invention for a fixed price payable in a lump sum or in installments. Installment payments permit more precise tax planning and may be used to defer income by scheduling the payments more advantageously.[5] A fixed price, however, has disadvantages for both the buyer and seller if their prediction of the invention's value is inaccurate.[6]

. . . [and they] do not interfere with the passing of ownership . . . from the assignee, but operate as conditions subsequent." *Id.* at 38.

[4] The term "royalty-type payments" refers to those determined on the basis of the productivity, use, or disposition of the patent rights.

[5] The inventor who receives royalty-type payments automatically spreads his income over a period of years and will thus pay less in total taxes even at ordinary income rates. If the inventor is allowed to transfer his patent and qualify for capital gains treatment, his already reduced tax bill will be further affected by the favorable treatment afforded capital gains.

[6] Valuation methods for use with fixed price sales and the advantages and disadvantages thereof are discussed in Cooper, "Tax Aspects of Corporate Exploitation of Inventions and Know-how," 38 S. Cal. L. Rev. 206, 237 (1965).

See also, e.g.: Fabricant, "Administering an IP Licensing Program," 1074 PLI/Pat 237 (Jan.-Feb. 2012) (noting that as businesses place more emphasis on IP assets, new methods of intellectual property valuation continually unfold, most of which employ variations of three basic approaches to valuing IP: the cost approach, the market approach, and the income approach); "Valuation of Intellectual Property: What, Why, and How," WIPO Magazine (Sept.-Oct. 2003) [cited in Gabala, "Intellectual Alchemy": Securitization of Intellectual Property as an Innovative Form of Alternative Financing," 3 J. Marshall Rev. Intell. Prop. L. 307 (Spring 2004)].

§ 1.03 Congressional Policy

Serious policy questions are raised with regard to the allowance of capital gains treatment for the transfer of patent rights. In part, the policy dilemma stems from the fact that an invention is the fruit of the inventor's labor; thus, payment for the invention necessarily compensates the inventor for his creative services. Income or compensation from personal services is usually treated as ordinary income even when personal efforts result in a tangible product such as a painting or a manuscript.[1] Further, the receipt of royalty-type payments over a period of time following a sale is arguably inconsistent with capital gains treatment, since one of the purposes of the lower effective tax rate on capital gains is to alleviate the effect of the "bunching" of income.[2] Notwithstanding these apparently inconsistent policies, Congress has been staunch in defending special treatment for inventors. Congress has twice acted to protect the favorable tax treatment extended to inventors.[3]

In 1950, Section 117(a) of the 1939 Code[3.1] was amended to exclude from capital asset status copyrights, artistic compositions, and several forms of intellectual property. At that time, the House passed a bill which included patent rights among those forms of intellectual property which would be so excluded. The Senate refused to agree with the inclusion of patent rights stating that "the committee believes that the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill. . . ."[4] The bill, which eventually passed without

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[1] I.R.C. § 1221(3); 26 U.S.C. § 1221(a)(3) specifically excludes copyrights and artistic compositions from capital asset status while held by the person whose personal efforts created the property. Thus, any sale of such properties will not be subject to capital gains treatment.

[2] The Commissioner frequently made this royalty argument in his early challenges to capital gains treatment of patent transfers, although installment reporting has been authorized since 1926 when the predecessor of current I.R.C. § 453 was enacted. Rev. Act of 1926, ch. 27, § 212(d), 44 Stat. 23.

See generally, Comment, "Capital Gains Treatment on Proceeds from Patent Transfers," 34 Mo. L. Rev. 98 (1969) (detailing the Commissioner's long fight against allowing capital gains treatment to various types of patent sales).

[3] See: Drennan, "The Patented Loophole: How Should Congress Respond to This Judicial Invention?," 59 Fla. L. Rev. 229 (April 2007); Cantor, "Tax Policy: Copyrights and Patents," 31 Vill. L. Rev. 931 (1986). Congress could have been more generous to inventors. See Irish Finance Act, 1969, § 28 (patent royalties exempt from income tax).

[3.1] Now I.R.C. § 1221; 26 U.S.C. § 1221.

[4] Rev. Act of 1950, Senate Report No. 2357, 1950-2 C.B. 483, 515.

reference to patent rights, contained only the exclusion set out in Section 1221(a)(3).[5] Congress acted again in 1954 by enacting a special safe-harbor provision which guarantees inventors capital gains tax treatment of the proceeds from certain transfers of their patent rights.[6] Congress enacted Section 1235 to eliminate the uncertainty caused by the Commissioner's continuing, albeit unsuccessful,[7] efforts to defeat capital gains treatment on the basis that royalty-type payments are inconsistent with a "sale" under the regular capital gains provisions, and to provide "an incentive to inventors to contribute to the welfare of the nation."[8]

Whenever faced with the issue, Congress has acted in a liberal and favorable manner toward the receipt of capital gains treatment by inventors for the proceeds from the sale of their patents. The Commissioner and the courts, however, have not always acted in the same liberal spirit.

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[5] 26 U.S.C. § 1221(a)(3) defines the term "capital asset" to exclude "a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property . . . ."

This difference in treatment remains, of course, a sore point between authors and inventors and has been severely criticized in a well-written student note. See, Note, "A Comparison of the Tax Treatment of Authors and Inventors," 70 Harv. L. Rev. 1419, 1424 (1957). See also, Hoffman, "Tax Planning for Authors," 26 Taxes 430, 443 (1968). See Chapter 8B *infra*.

[6] I.R.C. § 1235, 26 U.S.C. § 1235. Section 1235 applies to both gains and losses realized in the transfer of patent rights. The 1954 House bill (not enacted) would have limited its application to gains alone.

See also, e.g., Naik, "For Sale. Patents Never Used: Gaps in the Tax Code for Patent Sales," 11 J. Marshall Rev. Intell. Prop. L. 858, 866 (Spring 2012) (noting that Section 1235 was specifically enacted by Congress to provide individuals in the business of producing intellectual property such as patents the ability to benefit from lower capital gains treatment, rather than subject their income to ordinary income tax).

[7] Myers v. Commissioner, 6 T.C. 258 (1946), acq. 1946-1 C.B. 3, acq. withdrawn in part and nonacq. substituted 1950-1 C.B. 7, nonacq. withdrawn and acq. substituted 1985-2 C.B. 6.

[8] S. Rep. No. 1622, 83rd Cong., 2d Sess. 439 (1954). See Appendix B-4.