Tax Considerations of Acquiring Intellectual Property

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There are considerable differences in the tax treatment of intellectual property when the owner transfers it to an individual or business.

The tax rules surrounding intellectual property (IP) are indeed a tangled web that even experienced tax practitioners have trouble navigating. This circumstance is in part because the concepts are antiquated and have not kept up with innovations in technology and intellectual property law.

The tax law does not specifically define “intellectual property” or provide special rules that apply only to all types of intellectual property. Instead, patents, know-how, copyrights, trademarks, and trade names, as well as franchises, are, in most instances, lumped together with other intangible assets, such as goodwill, customer relationships, vendor relationships and covenants not to compete. However, as discussed below, certain special tax rules exist that benefit inventors and others who develop IP.

Tax advisors are often asked to opine on how best to structure a transfer of previously developed intellectual property (developed IP) in a tax-efficient manner. Developed IP can be a valuable asset and therefore often acquired, either as part of a going concern business or by itself. This article provides an overview of the principal tax concepts that acquirers of IP should consider. This article focuses primarily on acquisitions of previously developed IP, rather than developing IP. As IP can often be a major revenue generator for any business, tax advisors must be well-versed in addressing what entity should acquire the IP and where such entity should be located.

PATENTS, TRADEMARKS, SERVICEMARKS, & COPYRIGHTS

The drafters of the U.S. Constitution appreciated the significance of the development and protection of intellectual property in the United States:

The Congress shall have the power to promote the Progress of Science and
A copyright is a form of protection provided to the authors of “original works of authorship” including literary, dramatic, musical, artistic, and other works, both published and unpublished. The 1976 Copyright Act generally gives the owner of the copyright the exclusive right to reproduce the copyrighted work, to prepare derivative works, to distribute copies or phonorecords of the copyrighted work, to perform the copyrighted work publicly, or to display the copyrighted work publicly.

With that general overview of the types of IP, the remainder of this article addresses how these forms of IP are treated from a tax standpoint when they are acquired. Note also, multinational companies protect rights to their IP in most countries where the IP will be used. As discussed below, the tax laws also deal with the transfer of IP rights internationally as well as how the profits of the IP will be taxed.

CHARACTERIZING TRANSFERS OF IP

One of the critical issues in taxing IP is characterizing the transaction between the IP owner and the user. Developed IP is either transferred by a purchase or by a license. In general, if the IP owner relinquishes legal title and all substantial rights to the IP for a fixed payment, tax law characterizes the transaction as a sale of the underlying IP. On the contrary, if the IP owner retains substantial rights over the patent, the tax laws will classify such transfer as a licensing agreement. Most transfers of the use of IP, however, do not fall neatly into one of these two buckets. For example, the IP owner might retain title and transfer some or all of the economic rights. The characterization of the IP often is contingent on the productivity of the IP to the user. These transactions can lead to fine distinctions in characterizing the transaction for federal income tax purposes.

The tax ramifications of such fine distinctions must be discussed before the acquisition. Any developed IP that is sold can be eligible for treatment as a sale of a capital asset. In such case, the IP owner reduces the gain by his or her basis in the IP. However, the transfer of a license (other than as a contribution of capital) would generate royalty income generally subject to ordinary income rates. While the tax ramifications can be significant, the IP owner can, for very legitimate business reasons, demand the retention of certain rights over the IP. Such reasons must be weighed against the potential negative tax consequences.

Many tax authorities do not rely on the transfer of legal title to characterize the transaction between a sale and a license. Nor do those authorities rely on the characterization of the transaction under applicable IP law. The Supreme Court established over 100 years ago the general rule that to avoid the characterization of a licensing agreement and ordinary income treatment, the contract must provide the transfer of the right to make, the right to use, and the right to sell the patent right.

While in many instances the IRS attempts to use “substance over form” against taxpayers and the titles of their agreements, such doctrine can be used by taxpayers. In Watson, the Tenth Circuit provided that the fact an agreement is titled a Licensing Agreement is not the critical issue, but instead a court must look at the terms of the agreement to determine if the IP was sold or licensed.

The agreement between Watson and O’Donnell was entitled License Agreement, and in it the parties were referred to as licensor and licensee, respectively. But nomenclature of that kind has little if any significance in resolving the question whether the instrument amounted to an assignment or was a license. The
calling of the instrument a license agreement, and the denomination of the parties thereto as licensor and licensee, respectively, did not fix, limit, or qualify the scope and effect of the grant. The legal question whether the instrument constituted an effective assignment or was a license must be determined by considering together the several provisions contained in the instrument, not its title or the manner in which reference was made to the parties.

As Watson and other cases demonstrate, the contract terms, and the interpretation of those terms, regarding the actual transfer and use of the IP control the tax treatment. Notwithstanding, Watson further demonstrates that tax advisors should be consulted in the drafting of agreements for the transfer of IP to help ensure the terms of the agreement support the intended tax treatment.

Finally, a challenge for the tax adviser is communicating effectively with IP professionals regarding the tax characterization of IP transfers. In most instances, IP law focuses on the rights of the party that owns title to the IP while in certain instances, tax law looks at the substance of the transfer and the rights of the transferee over the IP as well as those retained by the transferor, if any. This differing analysis requires coordination between the tax adviser and his or her IP counterpart. Such coordination is very important to ensure that the IP is properly protected, but in the most tax-efficient manner.

**Section 1235**

If the IP is sold and not licensed, the seller would reference the rules under Sections 1221 and 1251 to determine the characterization of the asset. For example, Section 1221 specifically excludes from the definition of a “capital asset” a copyright, a literary, musical, or artistic composition, a letter or memorandum held by a taxpayer whose personal efforts created such property or in whose hands the basis of the property is determined. Section 1221 also excludes the letter or memorandum from the definition of a capital asset if the taxpayer is “for whom such property was prepared or produced.” While Section 1221 specifically limits the capital gain treatment for certain types of IP, Section 1255 provides favorable capital gain treatment for individual inventors.

Section 1255 provides:

A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of such transfers are

1. payable periodically over a period generally coterminous with the transferee’s use of the patent, or
2. contingent on the productivity, use, or disposition of the property transferred. (Emphasis added.)

Thus, if Section 1255 applies, the “holder” will receive long-term capital gain treatment regardless of holding period or other normal restrictions on nonindividuals, each individual partner’s distributive share of income attributable to the sale of the patent could qualify for long-term capital gain treatment under Section 1255.

Finally, tax advisers should review any relationship between the transferor/holder and the recipient of the rights to the patent when analyzing Section 1255. As noted, Section 1255 by its terms requires a transfer of all substantial rights to a patent. In a recent case, Cooper, 145 TC No. 10, the Tax Court concluded that a transfer to a corporation effectively controlled by the transferor did not constitute a transfer of all substantial rights because the transferor retained the substantial right to terminate the transfer by exercising his control over the corporation. While the transferor owned only 24% of the stock of the transferee, his sister-in-law and a long-time friend owned the remaining 76%. Further, the Court found that the sister-in-law and the friend never acted independently of the transferor in their capacities as directors and officers of the transferor. While the case turned on the specific narrow facts, it demonstrates that patent holders must be aware that any perceived “control” over the transferee could jeopardize Section 1255 treatment.

**In most cases, the transfer of any valuable IP rights to a corporation or partnership should achieve nonrecognition treatment under Sections 351 and 721.**

### NOTES

6. See Gregg, 18 TC 291 (1952), aff’d, 203 F.2d 954-43 AFTR 890 (CA3, 1953).
7. See Section 1221(a).
8. See Section 1235(b).
9. Reg 1235.2(d)(2).
10. Id.
Non-Section 1235 Transfers
The characterization of IP transfers that do not fall under Section 1235 for the seller is primarily the purview of the common law and the subject of numerous judicial battles between taxpayers and the IRS. The principal litigated issues regarding IP transaction characterization revolve around three features of IP transactions: contingent payments, geographical and field-of-use restrictions, and reservations of control.

Contingent payments. Initially, the IRS took the position that payments contingent on the transferee’s sales or profits, or similar measurements, or based on the transferee’s use of the patent.

Geographical and field-of-use restrictions. Owners of patents, copyrights, and other intangibles often limit licensees’ exploitation of the IP to specified geographical areas or fields of use. The IRS’s original position was that the IP was indivisible, so that geographical and functional divisions were indicative of a license even if the user obtained exclusive rights within the specified domain. Courts also rejected the IRS’s indivisibility theory of IP, which held that the transfer of exclusive rights to a patent, copyright, or trademark could be a sale for tax purposes even if restricted to a geographical area or a prescribed field of use. The IRS has also surrendered on this issue.

Reservations of control. An IP owner typically retains some control over geographical and field-of-use restrictions by requiring the assignee to adhere to quality and other standards prescribed by the assignor. A court must analyze whether such retention of rights constitutes the parties’ agreement to constitute a sale or a license. Drawing the line between “the reservation of sufficient rights and restrictions merely to protect [the taxpayer’s] continuing financial interest and the reservation of rights to continuing participation in the business on such a scale that it cannot properly be said that there was a sale” has proven problematic for courts.

Moreover, because the court analyzes both the conduct of the parties and their formal contract rights in determining whether the arrangement is a sale or a license, the outcome of these particular cases is of limited predictive value. Nonetheless, courts have addressed the tax ramifications of certain common contractual terms. For example, in Watson, 222 F.2d 689, 47 AFTR 925 (CA-10, 1955), the Tenth Circuit found that the owner of IP should be able to retain the right to terminate the transfer agreement under a condition subsequent whereby the buyer did not meet certain terms and expectations of the seller.

Generally, the cost of purchasing IP is not currently deductible, but is instead “capitalized” in the cost of the IP and recovered through ratable amortization over a period of years.

were like royalties (and therefore a license), because they were spread out over a period of years and gave the transferor a continuing interest in the property, and thus should not be given capital gains treatment. Had the courts agreed with this theory, many transfers of IP would not have qualified as a sale of the IP for tax purposes, because the difficulty of valuing IP usually dictates that the parties employ a royalty arrangement. Largely for this reason, the courts regularly rejected the IRS position and the IRS has long since conceded this issue. Thus, the transfer of patent rights may be classified as a sale when the seller’s consideration is measured by a percentage of the selling price, amounts per unit based on units manufactured or sold, or based on the transferee’s use of the patent.

In sum, the case law looks to whether the taxpayer disposes of all substantial rights in the underlying IP to distinguish between sales or exchanges of the IP and licenses of the IP. The more control that the owner places on the user’s use of the IP, the greater the likelihood of a characterization of the IP as a license.

CONTRIBUTION TO AN ENTITY VERSUS SALE OF IP
IP owners may transfer certain or all IP rights to a partnership or corporation for use in a trade or business. While the contribution of IP creates a realized taxable event, the question is whether such contribution generates a recognized taxable gain or loss under Section 721 for partnerships or
Section 351 for corporations. In most cases, the transfer of any valuable IP rights to a corporation or partnership should achieve nonrecognition treatment under Sections 351 and 721.

Section 351 prevents the recognition of gain or loss on the transfer of “property” to a corporation—foreign or domestic—in “exchange” for stock. While other limitations apply, the nonrecognition event under Section 351 applies only when the transferor (or multiple transferors) owns at least 80% of the stock of the transferee company as measured by voting power and by each class of nonvoting stock. Section 721 also requires the same transfer of “property” in “exchange” for a partnership interest for nonrecognition treatment of partners.

Neither the Code nor the regulations provide reliable definitions for the terms “property” and “exchange” included in Sections 351 and 721(a). Based on the similarity in the terms and purposes of the provisions, commentators and courts rely on decisions interpreting “property” and “exchange” under Section 351 for purposes of interpreting Section 721.14

The purpose of Sections 351 and 721 is to facilitate the flow of property from persons to business entities that will use the property productively but does not close out the transferor’s investment.15 Although the Code does not define “property” for purposes of Section 351 or 721, courts have given the term broad application, which generally “encompasses whatever may be transferred.”16

For years, the IRS asserted that Section 351 (and therefore Section 721) does not apply to a transfer of patent (and other IP) rights unless the transaction would rise to the level of a sale or exchange under Section 1001. Thus, the transferor would have to give up “all substantial rights” to the patent.19 According to the IRS, the retention by the transferor of substantial rights in the patent or other IP would constitute a license of IP rights and therefore not an “exchange” of property.18

The U.S. Court of Claims rejected the IRS’s assertion that a taxpayer must transfer “all substantial rights” and such rights must include an exclusive right in perpetuity for certain IP to qualify as “property” for purposes of Section 351.19 In E. I. Du Pont de Nemours & Co., 471 F.2d 1211, 51 AFTR 2d 75–614 (Cl. Ct., 1973), the Court of Claims considered whether a royalty-free nonexclusive license to make, use, and sell herbicides qualified as property under Section 351. Consistent with its prior rulings, the IRS argued that if a transaction does not qualify as a “sale or exchange” under the capital gain provisions of the Code, such transaction cannot be a “transfer” of “property” “in exchange” under Section 351. Since the proceeds of a grant of a simple nonexclusive patent license are not eligible for capital gains treatment, the IRS argued that DuPont failed Section 351. The Court of Claims found the IRS’s reliance on the capital gains provisions flawed as Section 351 and the capital gains provisions view the transfer of “control” in different, not similar, ways:

It is this cardinal element of continuing control by the taxpayer—i.e., that a third party does not at the time acquire substantial interest in the property transferred, or control over it—which supports the nonrecognition of gain under section 351.

In contrast, an important test for the capital gains provisions is whether there has been a full and complete divestiture by the taxpayer of his interests in the assets, and a corresponding acquisition of the property by a new owner. That is the precise reason why assignments of patents are held to fall under the protection of those sections, while an ordinary nonexclusive license is ruled not to be covered. The assignment represents full divestiture while a mere license bespeaks continued control of the heart of the patent by the owner. (Citations omitted.)

Once the court found the capital gains test did not apply, it said that “it is not difficult to find that the nonexclusive license handed over to the subsidiary was ‘property’ for purposes of Section 351. That holding appears consistent with the broad definition to be applied to the term ‘property’ for purposes of the nonrecognition provisions.

After DuPont, the IRS publicly stated it should no longer maintain that Section 351 requires the transfer of all substantial rights in a transaction that would constitute a sale or exchange for purposes of determining gain or loss and it should follow DuPont “in appropriate cases.”20 The authors can find no case that directly rejects DuPont.

**COSTS FOR “PURCHASED” IP**

Generally, the cost of purchasing IP is not currently deductible.21 but is instead “capitalized” in the cost of the IP and recovered through ratable amortization over a period of years.22 The method and term of amortization depends on the circumstances under which the taxpayer acquired the IP.

**Section 197**

Section 197 governs the amortization of many purchased IP assets. If Section 197 applies to an asset, the taxpayer amortizes the cost of the asset equally over the 180-month period beginning with the month of acquisition.23

**Patents and copyrights.** Section 197 applies to patents and copyrights,24 with two important exceptions. First, Section 197 does not apply to the costs of developing a patent or copyright by the taxpayer.25 Similarly, Section 197 does not apply to the purchase of a film, sound recording, video tape, book, or similar property in a transaction (or series of transactions) pursuant to which the taxpayer does not acquire the assets of a trade or business.26 Second, Section 197 is inapplicable to the purchase of a patent or copyright in a transaction (or series of transactions) pursuant to which the taxpayer does not acquire the assets of a trade or business.27 As a result, Section 197 applies only to patents or copyrights acquired by a taxpayer in connection with the purchase of a trade or business. Similar rules apply to a formula, process, design, pattern, knowhow, format, or other similar item.

**Franchises, trademarks, and trade names.** Section 197 applies to acquisitions of franchises, trademarks, and trade names, irrespective of whether the taxpayer acquires the asset in connection with the purchase of a trade
or business. Accordingly, the cost of acquiring a franchise is amortizable over a 15-year period regardless of the length of the franchise rights. Moreover, the cost of renewing a franchise is treated as a separate asset subject to a separate 15-year amortization period beginning with the month of renewal.28 The 15-year period does not apply to any unamortized cost of acquiring the original franchise (or prior renewals).29

**Computer software.** Section 197 applies to acquisitions of computer software subject to significant exceptions. For this purpose, “computer software” means any program designed to cause a computer to perform a desired function.30 Computer software does not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.31

Section 197 does not apply to acquisitions of computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.32 Section 197 also is inapplicable to other computer software that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a substantial portion or an entire trade or business. Accordingly, Section 197 applies only to the acquisition of customized software acquired (or subject to an exclusive license) as part of the acquisition of a trade or business.

**Treatment of contingent payments.** In many cases, the acquisition of IP includes payments made to the seller based on the productivity or use of the IP. Section 197 provides specific rules to determine the recovery of the contingent payments.

Purchase price contingency payments increase the basis of the acquired IP only when the contingency is met.33 Contingent amounts that become fixed during the 180-month period are amortizable over the remaining portion of the original 180-month period.34 Contingent payments that become fixed after the end of the 180-month period are immediately deductible.35 Thus, the acquirer of the IP should ensure that all contingency payments are well accounted for; because such delayed payments can provide immediate tax benefits.

**Losses on dispositions of Section 197 intangible assets.** Normally, when a taxpayer disposes of property at a loss or the asset becomes worthless, the taxpayer may deduct that loss in computing taxable income.36 However, Section 197 provides a special rule that applies to IP assets acquired in a transaction (or series of transactions) in which other assets subject to Section 197 amortization were acquired.

If the taxpayer later disposes of the IP asset at a loss (or the IP asset becomes worthless), and the taxpayer retains other intangible assets acquired in the transaction, the taxpayer may not deduct that loss.37 Instead, the basis of the retained intangible assets is increased by the amount of the disallowed loss.38 For this purpose, all entities under common control (as defined in Section 41) are treated as a single taxpayer for purposes of determining whether the taxpayer retains any acquired intangible assets.39

**Special rules related to computer software.** Computer software excluded from the application of Section 197 is generally depreciable if it is used in the taxpayer’s trade or business and is not inventory in the hands of the taxpayer.40 Thus, computer software purchased in a transaction that did not include the purchase of a trade or business would be depreciable under Section 167.

Computer software that is subject to depreciation is depreciated on a straight line basis over a 56-month useful life.41 Moreover, computer software that is subject to depreciation pursuant to Section 167 is also eligible to be expensed under the special rules of Section 179.42 Finally, computer software acquired and placed in service within the timeframes set forth in Section 168(k) qualifies for the 100% bonus depreciation deduction.43 The taxpayer must reduce the basis for depreciation under Section 167 by (1) the amount of such cost that is expensed under Section 179, and (2) the amount allowable as bonus depreciation under Section 168(k).44

**Section 167**

If Section 197 does not apply to the costs of acquiring IP, Section 167 determines the method of amortizing the cost. These rules would apply to the cost of purchased patents or copyrights not acquired in connection with the purchase of a trade or business. These rules would also apply to the cost of developing patents and copyrights, as well.

**Separately purchased patents and copyrights.** A special rule applies to purchased patents or copyrights with the purchase price payable on at least an annual basis as either a fixed amount per use or a fixed percentage of the revenue derived from the use of the patent or copyright. In that case, the amortization expense is equal to the amount of the purchase price paid or incurred during the year.45

**Other depreciation methods—patents and copyrights.** A taxpayer not using the method for contingent payments described above may amortize the cost of a patent or copyright using one of two approved methods. First, the taxpayer may depreciate the cost ratably over the legal life of the patent, under the so-called straight-line method.46 If a patent or copyright becomes valueless in any year before its expiration, the taxpayer may deduct the unrecovered cost or other basis in that year.47

Alternatively, the taxpayer may recover costs of the patent or copyright under the “income forecast method.”48 Pursuant to that method, the depreciation deduction for any year is computed by multiplying the property’s original basis by a fraction, the numerator of which is the income from the property earned in that year and the denominator is the anticipated total income from the property. The income estimate used in applying the method can include income for only the period consisting of the year that the property is placed in service and the succeeding ten years.49 The taxpayer must adjust the estimated rev-
revenues periodically to reflect changes in circumstances.50

Payments for "licensed" IP
If the tax law characterizes the acquisition of the IP as a license for federal income tax purposes, the payments for use of the IP are characterized as royalties. Generally, royalties incurred for IP used in the taxpayer’s trade or business are deductible as ordinary and necessary business expenses under Section 162.

One additional consideration applies to royalty payments made to non-U.S. owners of IP. A royalty is included in the definition of “fixed and determinable annual or periodic income.” Moreover, royalties for rights to use the IP in the U.S. may represent U.S. source income. Accordingly, such payments made to non-U.S. persons may be subject to the 30% federal income tax withholding pursuant to Section 1441, unless an applicable treaty reduces or eliminates the withholding rate.

Many license agreements make the licensee responsible for taxes imposed on a gross basis on the royalty payments. These provisions would generally make the licensee responsible for the withholding taxes imposed on the licensor. Tax advisors should review the applicable license and make sure that the licensee is aware of any potential exposure for withholding taxes.

IRS examinations involving IP
As demonstrated above, the rules pertaining to IP contain many pitfalls as well as opportunities. In recent years, the authors witnessed IRS exam teams scrutinizing the following issues with regards to IP: (1) research & development; (2) transfer pricing issues for all related party transactions; (3) cost sharing arrangements; (4) the sale (or acquisition) of IP to ensure the tax treatment is consistent with the analysis above; and (5) joint ventures with for-profit and nonprofit organizations. In many instances, the issues are resolved during the exam if the contemporaneous documentation supports the tax treatment. Thus, taxpayers are highly advised to plan for an IRS audit during the planning stages of the IP transaction rather than after receipt of the IRS audit notice. The IRS recently issued a “Transfer Pricing Audit Roadmap” to provide IRS personnel with audit techniques and tools to assist with the planning, execution, and resolution of transfer pricing examinations.53 In that way, the business purpose, valuation, and all other related issues are clearly set forth in the transactional documents rather than in oral testimony later during the audit. However, if the contemporaneous documentation does not exist, taxpayers are advised to secure letters and/or declarations from employees and third parties to confirm the elements are satisfied for the tax treatment reported.

Finally, the IRS Large Business and International Division issued in November 2013, and later supplemented, a directive outlining new procedures for IRS examiners to follow when issuing information document requests (IDRs) and the enforcement of the IDRs.54 The directive went into effect on 5/5/14.

Generally, the discussion about the new directive focuses on the short timeframe between noncompliance with an IDR by a taxpayer and the issuance and ultimate enforcement of a summons. However, an overlooked aspect of the new directive is the emphasis on the IRS exam team to obtain information from the taxpayer through direct conversations before the issuance of an IDR on a particular issue. Thus, the new directive places a heavy burden on the person speaking on behalf of the taxpayer because under the new procedures the IRS will “discuss the issue related to the IDR” before issuance of the IDR and “after the consultation with the taxpayer, determine what information will ultimately be requested in the IDR.”55 Taxpayers with IP issues that are raised during an examination have three options for representation to speak on its behalf before the IRS: (1) a company employee, such as a member from the tax department, (2) the outside return preparer, or (3) an outside representative not involved in the return preparation. Taxpayers should carefully weigh who is best to discuss the issues with the IRS exam team under the new directive because such discussions will lay the groundwork for the IDR on the IP and other issues.

Conclusion
As IP rights continue to evolve, tax advisors must be well-versed in the tax implications associated with the various forms of IP. The tax laws present significant differences in the tax treatment when an IP owner transfers developed IP to an individual or business. This article provides only the tip of the IP iceberg regarding how the IRS and the courts will view the terms of agreements governing the transfer of developed IP.  

NOTES
28 Section 197(f)(4).
29 Id.
30 Section 197(f)(1)(A)(i).
31 Id.
32 Section 197(f)(1)(A)(ii).
33 Reg. 1.197-2(f)(2)(i).
34 Id.
36 See Section 165.
37 Section 197(f)(1)(A)(ii).
38 Section 197(f)(1)(A)(i).
39 Section 197(f)(1)(C).
40 Section 167.
41 Section 165(b)(1).
42 Section 197(f)(1)(A).
43 Section 165(b)(2).
44 Reg. 1.197-1(b).
45 Reg. 1.197-4.
46 Id.
47 Id.
48 Sections 197(g)(6)(B) and (D).
49 Sections 197(g)(6)(A).
50 Sections 167(g)(1) and 881(a).
51 Sections 881(a) and 881(a).
52 Section 981.
55 Id.