

Bar Journal Author - Attorneys Peter T. Beach and Christopher J. Hamlen

Federal Income Tax Treatment of the Development, Acquisition and Disposition of Intellectual Property

The federal income tax treatment of intellectual property has evolved gradually over time and today involves a patchwork of significant statutory, administrative and common-law elements. Pulling all the rules together to determine the right tax treatment in a particular situation can be difficult. Adding to the complexity is the fact that the treatment selected during development or at the time of acquisition can affect the treatment that applies on disposition.

As with most tax issues, however, a systematic approach can remove a great deal of the uncertainty around tax planning for intellectual property transactions. Factors like the kind of intellectual property involved, the manner in which the property is developed, acquired or disposed of, and the nature of the consideration exchanged for the property are critical and provide useful anchors in what can otherwise be a bewildering sea of requirements. Even this factor-driven approach, however, cannot provide a simple decision tree for every situation. Rather it provides a framework in which to consider the appropriate tax treatment for broad categories of intellectual property in the context of three basic types of transactions – development, acquisition and disposition.

Types of Intellectual Property

Definitions of intellectual property typically refer to concepts like “intangible property,” “knowledge and ideas,” and “rights or entitlements” and then go on to list some or all of the following as examples of intellectual property: patents, copyrights, know-how, trade secrets, trademarks, trade names, and computer software. While the Internal Revenue Code of 1986, as amended, (the “Code”) contains many references to the types of property on this list, it did not contain the phrase “intellectual property” until the American Jobs Creation Act of 2004 added Section 170(m)¹ to address charitable contributions of intellectual property. Not surprisingly, the Code defines intellectual property for this purpose by reference to types of property: “any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property.”²

To engage in tax planning for the development, acquisition or disposition of intellectual property it is helpful to be generally familiar with the following types of intellectual property.

Patents. Patents are not defined in the tax law. They take their meaning from other laws that create the rights that are referred to as patents. Under US law, a patent is an intellectual property right conferred by congressional legislation and authorized by the Constitution.³ A grant of a patent under these laws is a “negative” right in that it accords no authority to make, use, or sell the subject invention, but rather, the right to exclude others from making, using, or selling the invention.⁴

Copyrights. Copyrights are not expressly defined for tax purposes either, but instead take their meaning from both the common law treatment of copyrights as well as treatment under federal statutory law.⁵ The Internal Revenue Service (“IRS”) has by regulation defined when the transfer of copyrighted materials constitutes the transfer of a copyright right.⁶

Know-how and Trade Secrets. Know-how has been defined for tax purposes, but the defining elements are more in the nature of directional signs than precise descriptors. For example, the Internal Revenue Service will characterize secret processes or formula used in a trade or business as property that may be subject to the Section 351 nonrecognition of income allowance upon transfer to a controlled corporation or partnership so long as the process or formula is held secret and the laws of the jurisdiction of the transferee provide the transferor with legal protection against the unauthorized disclosure of such information.⁷

Trademarks and Trade Names. Trademarks are not defined for tax purposes, but instead derive their meaning from US statutory law defining and addressing trademarks. The basic definition of a trademark is found in 15 U.S.C. § 1127, where the term is defined to include “any word, name, symbol, or device, or any combination thereof (1) used by a person, or (2) which a person has a bona fide intention to use in commerce and applies to register on the principal register established by this chapter, to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown.”

Computer Software. Computer software is defined for different tax purposes using varying, though roughly equivalent, definitions. Thus, for example, Treasury Regulation section 1.861-18(a)(3) defines a computer program as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.” This definition is generally used for purposes of addressing the treatment of income from the disposition of computer software. For purposes of addressing the treatment of development costs of software, Revenue Procedure 2000-50 defines a computer program as any program or routine (i.e., any sequence of machine-readable code) designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine.

Development of Intellectual Property

The primary tax issue that arises in connection with the development of intellectual property concerns the research and development deduction or tax credit. A taxpayer has several methods to choose from when deciding how to treat research and development (R&D) expenditures for tax purposes. Once the decision is made, it is generally memorialized in the form of an election made for the first tax year in which the expenditure is paid or incurred.

Many taxpayers and their tax preparers pay much less attention than they might to maximizing the impact of the R&D expense deduction and the R&D tax credit. Many are simply unaware that they can reduce taxes based on the nature of their day-to-day activities and those who are aware may not understand the breadth of coverage. The fact is that many businesses today invest heavily in product or process improvement to meet market demands and, therefore, can take advantage of the R&D expense deduction and R&D tax credit, both of which are designed to allow taxpayers to recapture some of the money spent in this way.

The R&D expense deduction

Section 174 permits a taxpayer to deduct or amortize R&D expenses⁸ that are paid or incurred during a taxable year in connection with a trade or business and which are not chargeable to a capital account. The taxpayer makes an election to deduct R&D expenses under section 174(a) or an election to amortize the expenditures under section 174(b). Amortization is allowed over a period not less than 60 months beginning with the month in which the process, formula or invention is first employed in an income-producing use.⁹ In deciding whether to deduct or amortize under Section 174, noncorporate taxpayers must also consider whether they will be subject to 10-year (rather than 60-month) amortization under the alternative minimum tax.¹⁰ Expenses for which no election is made (either to deduct or amortize) must be capitalized, i.e., included in the basis of the property or process being developed. The taxpayer must also substantiate the expenses if requested upon audit.

Not all expenses incurred in connection with research and development are covered by Section 174.¹¹ R&D expenses under Section 174 include only research and development costs¹² in the experimental or laboratory sense, i.e., costs that are incurred for activities intended to discover information that eliminates uncertainty as to the development or improvement of a product.¹³ Uncertainty exists if the information that is actually available to the taxpayer (not the broader category of information that might be reasonably available) does not establish the capability or method for developing or improving the product, or the appropriate design for the product.¹⁴ The regulations emphasize that whether an expenditure qualifies under Section 174 depends on the nature of the activity to which the expenditure relates not the nature of the product or improvement being developed, or the level of improvement that the technology represents.¹⁵ Finally, Section 174 applies not only to costs paid or incurred by the taxpayer for R&D that the taxpayer undertakes directly, but also to costs paid or incurred by him for R&D conducted on his behalf by another.¹⁶

Whether R&D expenses are incurred in connection with a trade or business, another requirement of Section 174, is broadly construed. In *Snow v. Commissioner*,¹⁷ the Supreme Court ruled that the test for R&D

expenses under Section 174 is broader than the test for deducting ordinary and necessary expenses of carrying on a trade or business under Section 162. Thus, a taxpayer who invests money in a partnership with an inventor can deduct his share of the partnership expenses in developing a product, even though the partnership hasn't yet sold or offered to sell its product and doesn't even have a patent pending, and therefore hasn't engaged in business for purposes of Section 162.¹⁸

Section 174 also requires that for R&D expenses to be deductible or amortizable they must not be chargeable to a capital account. A primary point to keep in mind in this regard is that before concluding that R&D expenses can be subject to Section 174 it must be determined that they are not required to be included in the basis of an intangible asset that is subject to 15-year amortization under Section 197, discussed below.

The R&D Tax Credit

Under Sections 41(a)(1), (2), and (3) the research tax credit equals: (1) 20 percent of the excess (if any) of the "qualified research expenses" for the taxable year over a "base amount;" (2) 20 percent of the "basic research payments;" and (3) 20 percent of the amounts paid or incurred (including contributions) to an energy research consortium by the taxpayer in carrying on any trade or business during the taxable year. "Base amount" and "basic research payments" are defined in a way that measures increased expenditures over a base period amount, thereby encouraging increasing research and development. Profitable companies can use the credits to reduce tax currently and for companies that pay no current tax, the credit can be carried over for 20 years.

Qualifying R&D costs are expenditures that qualify as R&D costs under Section 174 and meet three other tests under Section 41. "Qualified research" includes research undertaken for the purpose of discovering information¹⁹ that is technological in nature (the technical discovery test),²⁰ that is intended to be useful in the development of a new or improved business component of the taxpayer (the business component test),²¹ and with respect to which substantially all activities constitute elements of a process of experimentation that relates to a new or improved function, performance, or reliability or quality (the process of experimentation test).²² The statute also lists certain activities for which the credit is not allowed.²³

The R&D tax credit and R&D expense deduction can affect each other because the R&D tax credit reduces the R&D expense deduction for qualified research costs and basic research payments.²⁴ For example, if a corporation has qualified research costs of \$10,000 and a tax rate of 34 percent, the R&D expense deduction alone is worth \$3,400. Now assume that the R&D tax credit on the same qualified research costs is \$2,000. The corporation can take advantage of the credit and the deduction, but is not permitted to simply combine the deduction and the credit for a total tax reduction of \$5,400. Instead, the corporation must reduce the expenditure eligible for the deduction by the amount of the credit. On these facts, the R&D expense deduction is reduced to \$8,000 (\$10,000 - \$2,000) resulting in a tax reduction of \$2,720 (\$8,000 × 34 percent) and a credit of \$2,000 for a total tax reduction of \$4,720.

The R&D tax credit is also allowed for contract research expenses equal to 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.²⁵ The percentage is 75 percent for amounts paid or incurred (including contributions) to an energy research consortium²⁶ and 100 percent for eligible small businesses, universities, and federal laboratories for qualified energy research.²⁷

Development of Computer Software

The IRS has provided specific guidance on how to treat the cost of developing computer software because it believes that such costs "(whether or not the software is patented or copyrighted) are similar to the research and experimental expenditures that fall within the purview of Section 174 and thus warrant similar accounting treatment."²⁸ Under Rev. Proc. 2000-50, the IRS will not disturb a taxpayer's treatment of costs of developing computer software if the costs are accounted for in accordance with the following practices:

(1) All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under Section 174(a); or

(2) All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by Section 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in Section 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.

For purposes of Rev. Proc. 2000-50, "computer software" is defined as any program or routine (i.e., any sequence of machine-readable code) designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine.²⁹ "Costs" for this purpose includes all costs of computer software," except for costs that a taxpayer has treated as research or experimentation expenditures under Code Section 174.³⁰

It is important to note that Rev. Proc. 2000-50 isn't available for computer software costs that (1) are eligible for treatment as research and experimental expenditures under Section 174 if the taxpayer treats those expenditures under Section 174 (discussed above), or (2) are subject to amortization over 15 years under Section 197 (discussed below). However, some costs of software development will be excluded from Section 197 under the self-created property rules (discussed below) and will therefore be eligible for treatment under Rev. Proc. 2000-50.

Acquisition of Intellectual Property

The primary tax issue that arises in connection with the acquisition of intellectual property is whether, and the manner in which, a purchaser is required to amortize the purchase price of intellectual property under Section 197. Taxpayers acquiring intellectual property in any type of transaction must first consider the impact of Section 197 when analyzing their ability to deduct the consideration paid, regardless of whether the consideration is paid in the form of a lump-sum payment, contingent installments (e.g., license fees), periodic fixed installments, or renewal fees. Only after eliminating Section 197 as an option can a taxpayer turn comfortably to the other Code provisions that still apply to the deductibility of the consideration paid to acquire intellectual property.³¹ These provisions include Section 167 (depreciation), Section 162 (ordinary and necessary business expenses), and Section 174 (research and experimental expenditures), all discussed above.

Intellectual Property to Which Section 197 Applies

Section 197(a) permits a ratable deduction (i.e., amortization) over 15 years beginning with the month of acquisition for any "amortizable Section 197 intangible." Section 197 intangibles include any "information base," including business books and records, operating systems, technical manuals, training manuals or programs, data files, accounting or inventory control systems, and similar items.³² Section 197 intangibles also include know-how, formulas, processes, designs, package designs, patterns, formats, and similar items, patents, and copyrights.³³ This category also includes computer software and interests in films, sound recordings, videotapes, and books, with certain exceptions.³⁴ In general, computer software and interests in films, sound recordings, videotapes, and books, as well as patents and copyrights, are excluded from the application of Section 197 unless acquired with a trade or business or a substantial portion thereof.

Section 197 does not apply to any of the items described above if they were created by the taxpayer (so called self-created intangibles) and were not created in connection with a transaction involving the acquisition of assets constituting a trade or business or substantial part thereof.³⁵ Furthermore, the term Section 197 intangible does not include any interest in a patent not acquired as part of the assets constituting a trade or business, or substantial part thereof. This provision does not apply to know-how.

How Section 197 Applies to Particular Types of Intellectual Property

Once a taxpayer has identified the type of intellectual property acquired the next step is to determine how Section 197 applies with respect to that type of property, e.g., whether all or only some portion of the acquisition amount is amortized over 15 years.

Patents and copyrights (and certain computer software). Patents, copyrights, and computer software are subject to Section 197 only if they are acquired in, or created in connection with, the acquisition of

assets constituting a trade or business, or a substantial portion of a trade or business.³⁶ In determining whether the acquisition of a group of assets involves the acquisition of a trade or business or a substantial portion of a trade or business, Section 197 looks to the rules under Section 1060, which provide generally that the trade-or-business requirement is met if goodwill or going concern value could attach to the assets under any circumstances.³⁷ In the case of a trademark or trade name, the acquisition of such property in and of itself satisfies the trade-or-business requirement, unless it is included within the definition of either computer software or an interest in a film, sound recording, videotape, book, or other similar property, its value is nominal or the taxpayer disposes of it immediately after the acquisition.³⁸

With respect to patents and copyrights, once the trade-or-business requirement has been met, the property is subject to 15-year amortization. For computer software, however, two additional requirements must be met before the provisions of Section 197 apply:

(1) The software must be customized (i.e., it must not be readily available for purchase by the general public or subject to a nonexclusive license, or it must have been substantially modified).³⁹

(2) The price paid for the software must not be included, without being separately stated, in the cost of computer hardware or other tangible property acquired with the software.⁴⁰

Know-how. Acquisitions of know-how (other than self-created know-how) are treated differently than acquisitions of patents and copyrights. Section 197 applies to know-how regardless of whether the know-how was acquired in connection with the acquisition of a group of assets constituting a trade or business or a substantial portion of a trade or business.⁴¹ For self-created know-how to be covered by Section 197, however, it must be created in a transaction satisfying the trade-or-business requirement applicable to patent, copyright, and computer software acquisitions.⁴² Know-how is self-created if the actual work on the know-how is done by the taxpayer or by another person under a contract with the taxpayer entered into before development occurs.⁴³

Trademarks and Trade Names. Trademarks and trade names are treated differently from other types of intellectual property with Section 197 applying broadly to them. First, a trademark need not be acquired in connection with the acquisition of assets constituting a trade or business or a substantial portion of a trade or business for Section 197 to apply.⁴⁴ Second, any trademark or trade name acquired in a transaction that is not covered by Section 1253(d)(1) (dealing with royalty payments for transfers of trademarks and trade names) are covered by Section 197 since such trademarks, no matter how acquired, are deemed to have an amortizable basis.⁴⁵ Third, the acquisition of a self-created trademark or trade name is expressly covered under all circumstances.⁴⁶

Application of 15-Year Amortization

Once the taxpayer determines that the intellectual property acquired is subject to amortization under Section 197, application of the 15-year amortization requirement depends on the way in which the purchase price is paid – all at closing, in installments (whether fixed or contingent) and with renewal options.

Fixed Price Paid at Closing. When the total adjusted basis of the acquired property is paid at closing the taxpayer can begin writing off the price on the later of the first day of the month in which the closing occurs or, for property held in connection with the conduct of a trade or business or in an activity described in section 212, the first day of the month in which the active conduct of the underlying trade or business begins.⁴⁷

Generally, the most difficult issue encountered with a fixed price paid at closing is determining the adjusted basis of the intangible. If the intangible is acquired as part of a trade or business, the allocation rules of Section 1060 become relevant.

Fixed or Contingent Price Paid in Installments. Often the acquisition price for intellectual property will be spread over several years. The payments made after closing may be either fixed amounts (as in a common installment payment arrangement), contingent amounts (as in a licensing arrangement where payments are based on productivity, use or disposition), or a combination of both. The Treasury Regulations treat both required and contingent payments paid for a Section 197 intangible as payable under the terms of a debt instrument issued in exchange for property under Sections 483 and 1275.⁴⁸ Once these rules have been

applied to determine the amounts to be treated as payments of principal and the time at which these amounts are to be included in the basis of the assets, the amounts included in basis at closing are amortized over 15 years and the amounts included in basis after the first month of the 15-year period and before its expiration are amortized ratably over the remainder of the 15-year period.⁴⁹

To illustrate, assume a taxpayer agrees to pay \$100,000 at closing to acquire a patent in connection with the acquisition of a trade or business, plus up to \$50,000 each year over the next five years depending on the profits derived from the use of the patent. Further assume that based on actual productivity the seller earns the full \$50,000 in each of the five years and there is no imputed interest. The initial \$100,000 payment must be amortized over 15 years beginning with the month in which the closing occurred. Each additional \$50,000 payment is amortized over the remainder of the same 15-year amortization period, meaning that the five payments are amortized over 14, 13, 12, 11 and 10 years, respectively.

Renewals. Section 197(f)(4)(B) provides that the renewal of a trademark or trade name is an acquisition, but shall only apply to costs incurred in connection with the renewal. Consistent with this provision, the Treasury Regulations state that costs paid or incurred for the renewal of a trademark or trade name must be amortized over 15 years beginning with the month of the renewal.⁵⁰ The Treasury Regulations also provide that a renewal fee, for this purpose, includes any capitalizable amount paid or incurred to protect, expand, or defend a trademark.⁵¹

Avoiding the 15-Year Bright Line

The bright-line rule that Section 197 intangibles must be amortized over 15 years is the result of a legislative compromise that allows amortization for intangibles that were previously held to be nonamortizable and other intangibles that had been held to have determinable useful lives shorter than 15 years. Accordingly, the rule provides a benefit to some and a burden to others. Consider, for example, a taxpayer who purchases a business that holds a patent expiring in five years and would get a greater tax benefit by amortizing the cost of the patent over the remaining five years. On the other hand, consider a taxpayer who holds intellectual property that was not amortizable before Section 197 was enacted and would like to be able to amortize her investment under the new rule. In crafting the compromise, Congress was focused on reversing the tide of litigation over amortization of intangibles and, therefore, was not inclined to create exceptions that could gradually swallow the bright line rule and potentially lead to more litigation. As a result, opportunities to avoid the 15-year bright line rule are severely limited.

The Limited Duration Contract Right Exception. Under Section 197(e)(4), to the extent provided by regulations, Section 197 does not apply to any right, acquired other than in connection with the acquisition of assets constituting a trade or business or a substantial portion thereof, under a contract that has a fixed duration of less than 15 years. Applying this limited-duration contract right exception, the Treasury Regulations provide that when, in the ordinary course of business and not as part of the purchase of a trade or business, a taxpayer enters into a contract involving the use of know-how, the cost of acquired know-how can be amortized ratably over the period of the contract right.⁵² **This** exception does not apply to any contracts involving the use of a trademark or trade name. However, a taxpayer may be able to amortize the cost of a trademark or trade name over less than 15 years if the transaction can be structured to comply with Section 1253(d)(1), dealing with trademark license fees contingent on the productivity, use, or disposition of the trademark.⁵³

The Anti-Churning Rules. In some cases, taxpayers may want to apply, rather than avoid, the application of Section 197. For example, a taxpayer holding and using know-how or a trademark with an indefinite useful life may wish to transfer the property in a manner that would allow her to benefit from the transferee's ability to amortize the property over 15 years. A taxpayer might expect to be able to benefit in this way if the transferee were a related party or if the transferee were to license the property back to the taxpayer. Section 197, however, includes "anti-churning" rules designed to prevent this type of transaction. These rules prevent taxpayers from taking advantage of 15-year amortization by transferring previously nonamortizable intangible assets, such as goodwill, going-concern value, or any other Section 197 intangible not amortizable under prior law, to related parties.⁵⁴ In general, the anti-churning rules prohibit the amortization of any previously nonamortizable Section 197 intangible asset held or used by a related party at any time between July 25, 1991 and August 10, 1993.⁵⁵

Disposition of Intellectual Property

The principal tax issue confronted upon the disposition of intellectual property is whether the amounts realized by the transferor upon such disposition will qualify for capital gain treatment rather than as ordinary income. Attempts to obtain such preferential capital gain treatment by taxpayers generally involve one or both of the following considerations: (1) whether the asset transferred is properly classified as a capital asset rather than as a non-capital asset or the provision of services, and (2) whether the transfer should be treated as a sale or exchange of all substantial rights in such property or whether instead only a portion of the rights are transferred under what amounts to the grant of a license in such property.

Dispositions of Patents

The tax treatment of sales or exchanges of patents depends on whether the transferor is the developer of the patent or a party that has acquired the patent from a third party.

Disposition of Developed Patents. Section 1235 of the Code governs the transfer of a developed patent, and reads in relevant part:

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....⁵⁶

Under this provision, the transfer of a patent will qualify as the transfer of a capital asset if (1) the transferring party can be properly characterized as the developer of the patent (a "holder" under Section 1235), and (2) "all substantial rights" to the patent are transferred.

For an individual or entity to qualify as the "holder" of a patent he or she must be either the individual whose efforts created the patent or an individual who has acquired an interest in the patent "prior to actual reduction to practice of the invention covered by the patent," so long as such person is neither the employer of the creator or related to the creator.⁵⁷ Whether an individual's efforts created a patent is governed by federal patent law, and neither the Code nor applicable regulations address this issue. For a person to acquire an interest in a patentable invention before it is "reduced to actual practice," the acquisition must take place before the invention has been tested and operated successfully under operating conditions.⁵⁸

As noted above, the definition of a "holder" of a patent for Section 1235 purposes excludes employers and persons who are related to the inventor. As a result of this exclusion, an employer who holds the rights to a patent by virtue of the employment relationship with the inventor—as for example is the case when an employee-inventor is obligated to assign all rights in any patent to his or her employer under the work-for-hire doctrine—would not qualify as a "holder" for purposes of Section 1235, and therefore would not receive capital gains treatment on disposition of the patent.⁵⁹ The definition of "related person" in Section 1235 covers a broad range of relationships, including siblings, ancestors, lineal descendants, any corporation in which the inventor is the beneficial owner of more than 25 percent, any two corporations that are members of the same control group, various trust-related relationships (such as grantor-fiduciary and beneficiary-fiduciary), and persons owning more than 25 percent of the capital interest in a partnership.⁶⁰

If the transferor of the patent qualifies as a "holder" of the patent under Section 1235, then consideration must be given to whether the sale or exchange involves the disposition of "all substantial rights" in the patent, or an "undivided interest" therein. The term "all substantial rights" is defined by regulation as "all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred."⁶¹ The transfer is not of "all substantial rights" if it is limited geographically, limited in duration to less than the remaining life of the patent, limited to use within only certain trades or industries when rights to use of the patent in other trades or industries have value at the time of transfer, transfers less than all the claims or inventions covered by the patent,⁶² or retains for the transferor the right to terminate the transfer at will.⁶³ To own an "undivided interest" in all substantial rights in a patent, a person must own "the same fractional share of each and every substantial right to the patent."⁶⁴

If the disposition of a patent qualifies for treatment under Section 1235, then it is treated as the sale or exchange of a capital asset, and any gain received as a result of such transfer qualifies for long term capital gain treatment. If the disposition satisfies the "holder" test but fails the "all substantial rights" test, then it will be treated as the grant of a license and payments received as consideration for such license will be treated

as ordinary income. If the transferor does not qualify as the “holder” under Section 1235, then the disposition is treated as the transfer of an acquired patent under Section 1245 of the Code.

Disposition of Acquired Patents. Section 1245 of the Code applies ordinary income treatment to any gain or loss on the sale, exchange or other disposition of property that qualifies for a depreciation allowance under Section 167 of the Code.⁶⁵ Because a patent is useful to a business for only a limited period of time, the length of which can be estimated with reasonable accuracy, it is considered intangible property subject to treatment under Section 167.⁶⁶ Therefore, under Section 1245, the amount of the difference between the amount realized upon sale or exchange of an acquired patent (or, if lower, its recomputed basis) over the adjusted basis will be treated as ordinary income.⁶⁷

Dispositions of Know-How and Trade Secrets

Federal tax treatment of dispositions of know-how and trade secrets has not been codified in statutes or regulations, but instead is found in IRS revenue rulings and revenue procedures and in case law. Given the difficulty in defining these concepts it is not surprising that their treatment has been disparate

The proper characterization of know-how and trade secrets upon disposition depends principally upon one or both of two factors: (1) whether the disposition qualifies as a transfer of property that qualifies as a capital asset, rather than the provision of services that would qualify for ordinary income treatment, and (2) whether the disposition is in the nature of the transfer of all rights and interest in the know-how or trade secret that will be treated by analogy as the transfer of a capital asset under Section 1235, as opposed to a grant of a license that will again qualify only for ordinary income treatment.

Property vs. Services. The IRS first recognized the taxable nature of transfers of know-how in a revenue ruling addressing the taxation of a foreign corporation for revenue derived from the license of “technical knowledge, methods, experience, that is, the ‘know-how’ of the foreign corporation” involving the recovery and purification of chemicals.⁶⁸ It noted that “while manufacturing ‘know-how’ is nonpatentable, it is something that its possessor can grant to another for a consideration. The right to use such ‘know-how’ is not materially different from the right to use trademarks, secret processes and formulae, and, if the right to use it is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired under such agreement.”⁶⁹

The IRS’s concern with defining “know-how” arose in the context of determining whether it is properly classified as property that can be the subject of a sale or exchange that qualifies for treatment under Section 351 of the Code allowing for non-recognition of gain or loss upon the transfer of property for securities in a company.⁷⁰ Similarly, if it is not property, then it cannot constitute a capital asset or qualify for capital gains treatment as a capital asset, but instead constitutes services that are taxed at ordinary income rates.⁷¹

The IRS first recognized know-how in a revenue ruling addressing whether to treat the exchange of secret formulas or processes for a controlling interest in a company as qualifying for non-recognition of gain or loss under Section 351 of the Code. In that context the IRS defined know-how generally as “secret processes and formulas” or other “secret information as to a device, process, etc.” that is “in the general nature of a patentable invention without regard to whether a patent has been applied for.”⁷² The key elements according to the IRS in Rev. Rul. 64-56 are (1) whether the process or formula is secret, and (2) whether the laws of the jurisdiction to which the know-how is being transferred provide the transferor legal protection against the unauthorized disclosure of such secret process or formula.⁷³ The IRS later provided further detail with respect to these elements in a revenue procedure addressing the circumstances under which the IRS will determine that an agreement purporting to transfer know-how in exchange for securities will qualify for treatment as a capital asset under Section 351.⁷⁴ The IRS will consider: whether the information is secret and adequate safeguards have been taken to guard its secrecy against unauthorized disclosure and whether the information represents an original, unique and novel discovery, whether or not it is patentable.⁷⁵

If the process or formula qualifies as know-how under this general definition, then the extent to which it will be characterized as a capital asset will ultimately depend on the degree to which the payments provided are payments for property rather than as payments for services. If the services provided in conjunction with the transfer of know-how are “merely ancillary and subsidiary to the property transfer,” then the entire transaction will be classified as the transfer of property.⁷⁶ If the services provided are not ancillary and subsidiary to the property transfer, but secret processes or formula are transferred in conjunction with the

provision of services, then the consideration must be allocated between the services and the property.⁷⁷ If the transferee is paying primarily for the transferor to develop a formula or process that the transferee intends to maintain as secret know-how or a trade secret, then the transaction will not be viewed as the transfer of property but rather as the provision of services.⁷⁸

Treatment under Section 1235. In certain circumstances courts have taken the view that know-how is sufficiently akin to a patented invention to warrant treatment under Section 1235, if not directly then by analogy, when “all substantial rights” to the know-how are transferred in a transaction. For example, in *Pickren v. United States*,⁷⁹ the Fifth Circuit Court of Appeals reasoned that “[s]ecret formulas and trade names are sufficiently akin to patents to warrant the application, by analogy, of the tax law that has been developed relating to the transfer of patent rights.”⁸⁰ Pickren and a colleague had developed secret formulas used to prepare liquid wax products for lubricating furniture drawers. Pickren and his colleague licensed the formula and the rights to make products using the formulas to a company under a 25-year license that provided the licensors the rights to a royalty based upon the number of gallons of the product sold. After three years under the licensing agreement, Pickren transferred his entire rights and interest in the secret formulas to the licensee. At issue was the proper characterization of royalties received by Pickren for the three years during which the license was in place.⁸¹ Applying Section 1235 by analogy, the Fifth Circuit held that the language of the contracts under which the initial license was granted and the subsequent transfer of all remaining rights was effected made clear that under the initial agreement the parties did not intend to transfer “all substantial rights” to the formulas. Thus, for the three years in which the license was in effect, the payments received by Pickren were merely payments under a license subject to treatment as ordinary income.⁸²

There has been little consideration given to what types of trade secrets or know-how are sufficiently similar to patented inventions to qualify for treatment under the Section 1235 analysis upon transfer. Cases applying the “all substantial rights” analysis have generally assumed the likeness and have not given consideration to whether the definition and analysis provided in the Section 351 context applies equally well for consideration of Section 1235 treatment.⁸³

Dispositions of Trademarks and Trade Names

Section 1253 of the Code governs the treatment of income from the disposition of trademarks, trade names and franchises. Section 1253 contains two separate rules addressing the treatment of gain or loss upon the transfer of marks, names or franchises. As a “general rule,” the “transfer of a franchise, trademark, or trade name shall not be treated as a 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.”⁸⁴ The retention of “significant power, right, or continuing interest” includes a range of rights with respect to the transferred interest, including the following:

- (a) the right to disapprove all or part of the assignment of the interest;
- (b) the right to terminate the transfer at will;
- (c) the right to prescribe standards of quality of products used or sold, or of services furnished, or of equipment and facilities used to promote products or facilities;
- (d) the right to require that the transferee sell or advertise only products of the transferor;
- (e) the right to require that the transferee purchase substantially all of its supplies and equipment from the transferor; and
- (f) the right to payments contingent on the productivity, use or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.⁸⁵

The second rule in Section 1253 addresses the treatment of payments for a trademark, trade name or franchise that are contingent upon the productivity, use, or disposition of the trademark, trade name or franchise. Such contingent payments are treated as amounts received from the disposition of property that is not a capital asset, and thus qualifies for ordinary income treatment.⁸⁶

Section 1253, which came into effect for transactions entered into after 1969, was intended to supplant years of confused and unsettled case law on the treatment of transfers of trademarks, trade names and franchises.⁸⁷ Nevertheless, as one commentator has noted, the language of Section 1253 leaves unresolved a number of basic tax issues that may arise in the transfer of a trademark or trade name.⁸⁸ Suppose a trademark transferred for both a one-time payment at closing and the right to receive future payments contingent upon the productivity of the mark. Does the right to contingent payments disqualify the entire transfer from treatment as the transfer of a capital asset, or is it treated as a transfer of a capital asset with additional royalty payments that are treated as ordinary income? If the transfer is classified as the transfer of a non-capital asset, is it nevertheless treated as the sale or exchange of an asset the consideration for which will be treated as ordinary income but with the potential for basis recovery, or is it treated as the grant of a license that will not provide the transferor an opportunity for basis recovery? Section 1253 does not directly answer these questions. Nor have applications of Section 1253, whether by courts or the IRS.⁸⁹

Dispositions of Copyrighted Works and Computer Programs

Section 1221 governs the treatment of copyrighted works upon transfer. Section 1221 provides that copyrighted works are not "capital assets" in the hands of the creator of such work. Computer programs, because of their copyrightable nature, are often treated under Section 1221, and thus seldom qualify for capital gain treatment upon transfer. Where, however, the transfer of a computer program is property classified as the transfer of know-how, it may qualify for preferential capital gains treatment under Section 1235 applied by analogy.

Copyrights Generally. Section 1221 excludes from the definition of "capital asset" (and thus excludes the possibility of capital gains treatment for transfers of) copyrights that are held by "a taxpayer whose personal efforts created such property."⁹⁰ Section 1221 also provides that a copyright will not be treated as a capital asset in the hands of a person or entity whose basis in the copyright is determined in whole or in part by reference to the basis of the copyright in the hands of the creator of such copyright.⁹¹ This provision is intended to prevent circumvention of the basic rule by use of a tax-free transfer provision, such as by way of a transfer to a corporation or partnership that would qualify for treatment under Section 351 or 721 of the Code. The regulations under Section 1221 have expanded the reach of non-capital asset treatment for copyrighted works in the hands of a creator to "property eligible for copyright protection (whether under statute or common law)," excluding a patent or invention.⁹²

Computer Programs. Computer programs are classified under one of four categories created by regulation for purposes of analyzing their transfer and proper classification as either a sale or exchange (and thus their ability to qualify as the transfer of a capital asset), or a license or lease that would generate royalty or lease income.⁹³ The four categories are as follows:

- (i) A transfer of a copyright right in the computer program;
- (ii) A transfer of a copy of the computer program (a copyrighted article);
- (iii) The provision of services for the development or modification of the computer program; or
- (iv) The provision of know-how relating to computer programming techniques.⁹⁴

Treasury Regulation Section 1.861-18 provides guidance on how to categorize a transfer of a computer program as the transfer of a copyright right, the transfer of a copy of the computer program, or the provision of know-how. A transfer is of a copyright right if it includes any of the following: the right to make copies of the computer program for purposes of distribution to the public by sale, rental or lease; the right to prepare derivative computer programs based upon the copyrighted program; the right to make a public performance of the computer program; or the right to publicly display the computer program.⁹⁵ A transfer is of a copy of the computer program if none of the above indicia are present and the transfer involves only the provision of a copy of the program with the right to use the program.⁹⁶ A transfer constitutes the provision of know-how only if *all* three of the following are present: the information transferred relates to computer programming techniques; the information is furnished under conditions preventing unauthorized disclosure, and such prevention has been contracted for between the parties; the information is considered to be property that is subject to trade secret protection.⁹⁷

Classification as Sale or Exchange verses License or Lease. *To obtain favorable capital gain treatment for transfers involving a computer program, the transfer must be classified as either the sale or exchange of a copyright right in a transaction that will not trigger the capital asset exclusion under Section 1221 of the Code, or as the provision of know-how in a transaction that is treated by analogy under Section 1235 of the Code as discussed earlier in this article. In all other circumstances, the transferor will be treated as having ordinary income, either from the sale or exchange of a non-capital asset or from the license or lease of the computer program.*

As with the sale or exchange of developed patents, trademarks and trade names, whether the disposition of a copyright right constitutes the sale or exchange of the right rather than simply the grant of a license that generates royalty income depends on whether, "taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright."⁹⁸ While applicable treasury regulations state that the principles in Sections 1222 and 1235 may be applied in evaluating the transfer of a computer program,⁹⁹ it is not clear how far the analogy goes. For example, while the transfer of a developed patent that is limited in geographic scope does not qualify for capital asset treatment under Section 1235 of the Code, Treasury Regulation § 1.1861-18(h) provides as an example of a sale or exchange of a copyright right the grant of an exclusive license for the remaining term of a copyright to copy and distribute copies of a software program within the limited geographic area of a particular country.¹⁰⁰

Disposition of Intellectual Property: The Realities of Complex Transactions

Transfers of intellectual property increasingly involve the sale and/or license of a range of products and services that are not easily broken down into the discreet categories of patent, copyright right, trade secret/know-how, and not easily categorized as a sale or license. This is due at least in part to the increased use of technology and other forms of intellectual property to address complex business issues and business arrangements.

At the same time, lawyers in general are loath to create new forms of agreement or transaction that might better capture the nuances of a proposed transaction, and courts are quick to try and classify transactions into traditional categories: sale vs. license, joint venture vs. services agreement or outsourcing agreement. This can make it difficult to take advantage of, for example, the favorable tax treatment that might be provided to dispositions of know-how, trade secrets, and non-created copyrights if the agreements were drafted in a way that more clearly identified the nature of the intellectual property and the nature of the disposition.

The recent case of *Vision Information Services, L.L.C. vs. Commissioner of Internal Revenue* illustrates the difficulty.¹⁰¹ Vision Information Services ("Vision") was the joint creation of two technology companies, created to market and provide inventory information management services to manufacturers, distributors, and retailers. These services were provided through a software package that vision licensed from one of its parent companies.¹⁰² At issue in *Vision Information Services* was Vision's treatment of income received from the provision of inventory management services to FoxVideo under a complex set of agreements that the companies had entered into. For years 1995 and 1996, FoxVideo had paid Vision \$3 million and \$1.75 million in so-called "licensing fees," and Vision reported those payments as an installment sale of "exclusive rights & know how," treating the payments as qualifying for long-term capital gain treatment.¹⁰³ The IRS determined that the payments were license fees taxable as ordinary income, and Vision challenged this determination.¹⁰⁴

The substance of Vision's agreement with FoxVideo was as follows. Vision would provide software and services that would allow FoxVideo to sell its products directly to retail stores rather than sell through a distributor. Vision's software, significantly enhanced to accomplish these purposes, would be used to track the sale of FoxVideo products in retail stores to determine whether product needed to be replenished. In addition, FoxVideo outsourced the entire operation to Vision, so that Vision was directly responsible for ensuring that the software system and entire inventory management operation worked appropriately. According to testimony at trial, "the concept of Vision was to develop a capability without [Vision]'s clients having to invest heavily into technology and processes, and to amortize this capability, perhaps across, in the future, many customers, in many different areas."¹⁰⁵

The agreements used to document the arrangement included a "Distribution Information Services Agreement" ("Distribution Agreement") and, as a part of the Distribution Agreement, a conditional license of Vision software to FoxVideo ("License Agreement").¹⁰⁶ The heart of the Distribution Agreement was a

provision that called for Vision to provide "Information Services with respect to the distribution of any product distributed by FoxVideo."¹⁰⁷ The initial term of the agreement was for five years, with an extension right held by FoxVideo for an additional five-year term. The agreement contained an exclusivity provision that required FoxVideo to obtain Information Services exclusively from Vision for distribution services in the United States and Canada, however Vision was free to provide similar services so long as such services were not provided to the home video division of any major studio.¹⁰⁸

The License Agreement provided for a license of the Vision software that Vision was to use in providing the distribution services. However, FoxVideo was only allowed to exercise the license upon termination of the outsourcing agreement between the parties. Thus, the licensing agreement provided FoxVideo the opportunity to bring the inventory management services in house if it so chose.¹⁰⁹

Vision argued to the court that despite the language of the two agreements,¹¹⁰ the entire transaction taken together should be viewed as "a sale of trade secrets and know-how of the direct-to-retail business model to FoxVideo" that would qualify for capital gains treatment under the Section 1235 standard applied to the disposition of know-how in cases such as *Pickren*.¹¹¹ The court rejected this argument for a range of reasons:

1. Analyzing the language of the agreements, the court noted that the \$3 million and \$1.75 million payments in question were clearly designated as licensing fees in the Licensing Agreement.¹¹²

2. Nothing in the agreements refers to the transfer of "trade secrets" or "know-how." Instead, the agreements indicate that Vision was providing inventory management services through the use of its own software as well as a license of the software in the inventory the outsourcing services were ever terminated. Because the language of the agreement is clear and unambiguous, extrinsic evidence in the form of oral testimony regarding the parties' actual intent is not necessary.¹¹³

3. Looking beyond the language of the agreement, there is no indication that the services provided involved the transfer of know-how or trade secrets. Vision was to *use* its know-how and trade secrets to provide outsourcing services, not *transfer* the know-how and trade secrets to FoxVideo.¹¹⁴

4. Even if it is assumed that the transaction involved the transfer of know-how and trade secrets, the transaction would not pass the "all substantial rights" test under Section 1235 of the Code. Vision was free to provide the same services to other companies not in the home video business, and the arrangement only applied to FoxVideo's operations in the U.S. and Canada.¹¹⁵

Given the manner in which the parties structured this transaction, including in particular the designation of the payments in question as licensing fees, it is difficult to argue with the court's conclusion that the fees were not for the sale or exchange of know-how and trade secrets, but were instead for the grant of a license and services that qualified for ordinary income treatment.

Consider, however, whether the substance of the transaction did not in fact involve, at least in part, the provision of know-how that might have qualified for capital gain treatment? FoxVideo was not simply looking for a computer program that would allow it to track inventory at retail stores. It was looking to change the nature of its inventory distribution entirely by removing the relationship with distributors. It contracted with Vision to implement this change using software and procedures that Vision had created. The grant of the conditional license gave FoxVideo the ability to continue utilizing the Vision inventory management system once FoxVideo had learned how the system worked. Had the parties memorialized their understanding in documents that addressed the importance of certain trade secrets or know-how to the proper implementation of the inventory management system, and had the parties allocated some of the income from the arrangement specifically to the transfer of such trade secrets and know-how, Vision may have avoided the courts conclusion, at least with respect to a portion of the fees.

The court's analysis in *Vision Information Services* highlights the difficulty in obtaining favorable tax treatment for transfers of intellectual property. Technology and other forms of intellectual property are used increasingly to address complex business problems, and the arrangements that parties enter into to accomplish those purposes are correspondingly complex. It is frequently necessary to couple the grant of a software license with substantial support and training services. Whether these transactions, taken together, should be viewed as involving the transfer of trade secrets and know-how and not simply the grant of

software licenses and the provision of training services is a consideration that should be addressed at the outset of such arrangements, so that the documentation for such arrangements can properly reflect the substance of the transaction.

Conclusion

Analyzing the tax treatment of the development, acquisition and disposition of intellectual property is not an easy task. For each type of transaction there are potentially different rules for each category of intellectual property and some types of property may fit into more than one category. On top of that, the rules dealing with each category of intellectual property for each type of transaction may include election and planning decisions based on rules that are at best difficult to understand and in many instances impossible to apply with any satisfactory degree of certainty. In other words, this area of tax law is a lot like most areas of tax law, in that sound planning requires a nose-to-the-grindstone type application of a methodical approach. Finally, as the *Vision Information Services* case highlights, involving a tax lawyer in the early stages of a transaction involving intellectual property can be critical to future outcomes. If a tax lawyer had been involved in structuring that transaction, he or she would have had the opportunity to ask questions about exit strategies and make suggestions as to the manner in which the agreements were drafted. Without such input, the transaction lawyers simply structured the transaction in a form with which they were familiar, with the unhappy result illustrated by that case.

ENDNOTES

1. All "Section" "§" references herein are to the corresponding sections of the Internal Revenue Code of 1986, as amended, and the final, temporary, and proposed Treasury Regulations promulgated thereunder.
2. IRC Section 170(e)(1)(iii).
3. See 35 USC § 100 *et seq.*
4. See 35 USC §§ 154, 271.
5. See 17 USC § 101.
6. A transfer is of a copyright right if it includes any of the following: the right to make copies of the computer program for purposes of distribution to the public by sale, rental or lease; the right to prepare derivative computer programs based upon the copyrighted program; the right to make a public performance of the computer program; or the right to publicly display the computer program. Treas. Reg. § 1.1861-18(c)(1)(i) and 1.1861-18(c)(2). These circumstances are discussed in more detail in this article.
7. See, e.g. Rev. Rul. 64-56, 1964-1 C.B. 133 (addressing whether the transfer of rights to use certain secret manufacturing processes in exchange for stock in the transferor constitutes the transfer of property that may qualify for Section 351 non-recognition of gain treatment); Rev. Proc. 69-19, 1969-2 C.B. 301 (setting forth the conditions under which the IRS will issue a ruling that the transfer of "know-how" in exchange for securities constitutes a transfer of property qualifying for treatment under Section 351).
8. The statute actually refers to them as "research and experimental" expenditures.
9. Treas. Reg. § 1.174-4(a)(3)
10. For alternative minimum tax purposes, R&D expenses must be capitalized and deducted ratably over 10 years, unless the taxpayer materially participates in the research or experimentation activity. IRC Section 56(b)(2)(A)(ii). This adjustment effectively reduces the deduction for alternative minimum tax purposes in the year expenditures are paid or incurred (when the entire amount would have been deducted for regular tax purposes) and increases it in later years (when the amortization deduction is allowed for alternative minimum tax but not for regular tax purposes).

11. Treas. Reg. § 1.174-2(a)(3) provides that the following expenditures do not qualify: (1) the ordinary testing or inspection of materials or products for quality control (quality control testing); (2) efficiency surveys; (3) management studies; (4) consumer surveys; (5) advertising or promotions; (6) the acquisition of another's patent, model, production or process; or (7) research in connection with literary, historical, or similar projects.

12. Including all costs that are incident to the development or improvement of a product, such as attorney's fees incurred in obtaining a patent.

13. Treas. Reg. § 1.174-2(a)(1). A "product" for these purposes includes any pilot model, process, formula, invention, technique, patent, or similar property, whether to be used by the taxpayer in its trade or business or held for sale, lease, or license. *Id.*

14. *Id.*

15. *Id.*

16. Treas. Reg. § 1.174-2(a)(8)

17. 416 US 500 (1974).

18. Note, however, that since enactment of the passive activity loss provisions of Section 469, if the investor's interest in the partnership were not a general partner interest her deduction would likely be suspended.

19. The Treasury Regulations under Section 41 are similar to those under Section 174 in this regard. Treas. Reg. § 1.41-4(a)(3) provides that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

20. IRC Section 41(d)(1)(b)(i). Treas. Reg. § 1.41-4(a)(4) provides that information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science.

21. IRC Section 41(d)(1)(B)(ii). A business component is defined as "any product, process, computer software, technique, formula or invention which is to be held for sale, lease or license, or used by the taxpayer in a trade or business of the taxpayer." IRC Section 41(d)(2)(B)

22. IRC Sections 41(d)(1)(C) and 41(d)(3).

23. IRC Section 41(d)(4)(A)-(D). The listed activities are: (A) any research conducted after the beginning of commercial production of the business component; (B) any research related to the adaptation of an existing business component to a particular customer's requirement or need; (C) any research related to the reproduction of an existing business component; and (D) any efficiency survey, activity relating to management function or technique, market research, testing, or development (including advertising or promotions), routine data collection, or routine or ordinary testing or inspection for quality control.

24. IRC Section 280C(c). If a taxpayer elects to capitalize the costs under Section 174 the amount capitalized is likewise reduced.

25. IRC Section 41(b)(3)

26. IRC Section 41(b)(3)(C)

27. IRC Section 41(b)(3)(D)

28. Rev. Proc. 2000-50, 2000-2 C.B. 601.

29. The definition includes all forms and media in which the software is contained, whether written, magnetic or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines and utility programs as well as application programs, are included. Also included are any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software.

30. A series of private letter rulings concerning Rev. Proc. 69-21, 1969-1 C.B. – which before it was superseded by Rev. Proc. 2000-50, applied to “all” costs properly attributable to software development – permitted application of the Rev. Proc. only with respect to software development costs that were “similar to research and experimental expenditures . . . that qualify under the provisions of section 1.174-2 of the regulations.” See, e.g., Private Letter Rulings 9345012 and 9331057 through 9331061. This restriction appears inconsistent with the explicit statement in Rev Proc 2000-50 that it applies to “all” computer software costs except for costs treated as research or experimentation expenditures under Section 174. Because the private letter rulings cited involved requests for the IRS to consent to a change in method of accounting, presumably, the restrictive approach taken simply illustrates the IRS’s power to attach conditions to such consents, rather than an interpretation of Rev Proc 69-21 (and, by extension, Rev Proc 2000-50).

31. IRC Section 197(b) (except as provided in section 197, “no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible”).

32. IRC Section 197(d)(1)(C)(ii); Treas. Reg. § 1.197-2(b)(4).

33. IRC Section 197(d)(1)(C)(iii); Treas. Reg. § 1.197-2(b)(5).

34. Treas. Reg. § 1.197-2(b)(5); Treas. Reg. § 1.197-2(c).

35. The Conference Committee Report that accompanied enactment of Section 197 includes in the definition of “self-created” intangibles an intangible produced by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. [cite] However, the same report provides that the costs of entering into, or a renewal of, a contract for the use of an intangible such as know-how are a Section 197 intangible and must be amortized over 15 years. [cite]

36. See Sections 197(e)(3)(A)(ii) and (4)(C); Treas. Reg. § 1.197-2(c)(4)(ii) and (7). Treas. Reg. § 1.197-2(e) (acquired in, or created in connection with). Whether acquired assets are a substantial portion of a trade or business depends on all the facts and circumstances, and the relevant factors include the nature and amount (but not necessarily the value) of both the acquired assets and the assets retained by the transferor. Treas. Reg. § 1.197-2(e)(4).

37. Treas. Reg. § 1.197-2(e); Treas. Reg. § 1.1060-1(b)(2).

38. Treas. Reg. § 1.197-2(e)(2).

39. Treas. Reg. § 1.197-2(c)(4)(i); Treas. Reg. § 1.197-2(k), Example 2.

40. Treas. Reg. § 1.197-2(c)(4)(iii); Treas. Reg. § 1.197-2(g)(7).

41. IRC Section 197(e)(4); Treas. Reg. § 1.197-2(c)(7).

42. IRC Section 197(c)(2); Treas. Reg. § 1.197-2(d)(2)(ii) and (iii).

43. Treas. Reg. § 1.197-2(d)(2)(ii)(A) (citing as an example, a technological process developed specifically for a taxpayer under an arrangement with someone else, pursuant to which the taxpayer keeps all rights to the process).

44. See Sections 197(c)(2) and (e)(4). In addition, the Treasury Regulations state that the acquisition of a trademark or trade name generally is the acquisition of a trade or business or a substantial portion thereof. Treas. Reg. § 1.197-2(e)(2).
45. IRC Sections 197(f)(4)(C) and 1253(d)(2); Treas. Reg. 1.197-2(b)(10)(ii) and (g)(5). Section 1253(d)(1) allows a taxpayer to deduct trademark royalty payments currently as an ordinary and necessary business expense if the royalty payments made under a trademark license are contingent on the productivity, use, or disposition of the trademark; are payable at least annually throughout the term of the transfer agreement; and are substantially equal in amount or payable under a fixed formula.
46. Treas. Reg. § 1.197-2(d)(2)(iii)(A) (stating that exception for self-created intangibles does not apply to trademarks and trade names and that Section 197 applies to the capitalized costs that a taxpayer incurs in connection with the development, registration, or defense of a trademark); Treas. Reg. § 1.197-2(k), Example 8.
47. Treas. Reg. § 1.197-2(f)(1)(i).
48. Treas. Reg. § 1.197-2(f)(2)(iii).
49. Treas. Reg. § 1.197-2(f)(2)(i).
50. Treas. Reg. § 1.197-2(f)(4).
51. *Id.*
52. Treas. Reg. § 1.197-2(c)(13)
53. Treas. Reg. § 1.197-2(g)(6).
54. For purposes of the anti-churning rules, deductions allowable under Section 1253(d) as in effect prior to the enactment of Section 197 are treated as deductions allowable for amortization under prior law. Treas. Reg. § 1.197-2(h)(3). As a result, the anti-churning rules, which only apply to intangibles that were previously not amortizable, do not apply to, for example, a trademark currently being amortized over 25 years under former Section 1253(d)(2) or (3).
55. Specifically, the anti-churning rules prohibit the amortization of any previously nonamortizable intangible assets acquired after August 10 1993 (the “applicable effective date”) if (1) the taxpayer or a related person held or used the intangible asset or any interest therein at any time during the transition period, (2) the taxpayer acquired the intangible asset from a person who held the asset at any time during the transition period and, as part of the transaction, the user of the asset does not change, or (3) the taxpayer grants the right to use the intangible asset to a person who held or used the asset at any time during the transition period (or to a person related to that person). IRC Section 197(f)(9)(A); Treas. Reg. § 1.197-2(h)(2). The third category only applies to transactions in which the granting of the right and acquisition of the intangible asset are part of a series of related transactions. Treas. Reg. § 1.197-2(h)(2)(iii).
56. IRC Section 1235(a). Note that this provision does not require that the patent be *held* for more than one year in order for long term capital gain treatment to apply upon transfer. Rather, long term capital gain treatment is afforded to the transferor upon disposition regardless of the holding period.
57. IRC Section 1235(b).
58. A patentable invention is “reduced to actual practice” when it has been “tested and operated successfully under operating conditions.” Treas. Reg. § 1.1235-2(e) (cross-referencing to 35 U.S.C. 102(g)). This might occur before or after the inventor has applied for a patent, but it cannot occur after there has been commercial exploitation of the invention. *Id.*

59. Note that it is a separate question whether payments received by the *employee* for transfer of rights in a patent to an employer qualify for Section 1235 capital gains treatment. Treas. Reg. § 1.1235-1(c)(2) states that “whether payments received by an employee from his employer (under an employment contract or otherwise) are attributable to the transfer by the employee of all substantial rights to a patent (or an undivided interest therein) [and thus qualify for §1235 treatment] or are compensation for services rendered the employer by the employee is a question of fact. In determining which is the case, consideration shall be given not only to all the facts and circumstances of the employment relationship but also to whether the amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee. If it is determined that payments are attributable to the transfer of patent rights, and all other requirements under section 1235 are met, such payments shall be treated as proceeds derived from the sale of a patent.”

60. *See* IRC § 1235(d) (incorporating by reference the relationships set out in I.R.C. § 267(b) and 707(b)).

61. Treas. Reg. § 1.1235-2(b)(1).

62. *Id.*

63. Treas. Reg. § 1.1235-2(b)(4). Treas. Reg. § 1.1235-2(b) also states that rights which are *not* substantial for purposes of Section 1235 may be retained by the transferor. For example, the transferor may retain legal title for the purpose of securing performance by the transferee of an exclusive license to manufacture, use and sell for the life of the patent. Treas. Reg. § 1.1235-2(b)(2)(i). Treas. Reg. § 1.1235-2(b) also provides examples of rights that may or may not be substantial, depending upon the circumstances of the transaction, including the retention by the transferor of a right to prohibit sublicensing or subassignment of the patent and the failure to convey to the transferee the right to use or sell the patent property. Treas. Reg. § 1.1235-2(b)(3).

64. Treas. Reg. § 1.1235-2(c).

65. Section 1245(a).

66. Generally, Section 167 allows for a depreciation deduction for any property used in a trade or business or held for the production of income. Section 167(a). The regulations for Section 167 further specify that if an intangible asset is known from experience or otherwise to be of use in the business or production of income *for only a limited period of time*, the length of which can be estimated with reasonable accuracy, then a depreciation allowance will apply to such an intangible property. Treas. Reg. § 1.167(a)-3(a). A patent is provided as one example of such property. *Id.* Note that, as described in the text accompanying footnote 34, Section 197, not section 167, only applies to a patent acquired in, or in connection with the acquisition of assets constituting a trade or business, or a substantial portion of a trade or business.

67. Section 1245(a)(1). Notwithstanding this general rule, the sale or exchange of a patent that has been used in a trade or business for more than one year may qualify for long term capital gains treatment under Section 1231 of the Code if the amount of the Section 1231 gains in a year exceed the amount of Section 1231 losses in that year. *See* Section 1231(a)(1). Generally speaking, “Section 1231 gain” is “any recognized gain on the sale or exchange of property used in the trade or business.” Section 1231(a)(3)(A). Treas. Reg. 1.1245-1(b) provides a number of helpful examples of the application of Section 1231 to establish the long term capital gains treatment for certain dispositions of capital assets.

68. Rev. Rul. 55-17, 1955-1 C.B. 388.

69. *Id.*

70. *See, e.g.* Rev. Rul. 64-56, 1964-1 C.B. 133 (addressing whether the transfer of rights to use certain secret manufacturing processes in exchange for stock in the transferor constitutes the transfer of property that may qualify for Section 351 non-recognition of gain treatment); Rev. Proc. 69-19, 1969-2 C.B. 301 (setting forth the conditions under which the IRS will issue a ruling that the transfer of “know-how” in exchange for securities constitutes a transfer of property qualifying for treatment under Section 351).

71. The Tax Court recognizes the inherent difficulty in classifying know-how as either property or services. See, e.g. *Ofria v. Commr.*, 77 T.C. 524, 535 (1981) (“The difficulty in determining whether payments to a creator of an invention or valuable commercial process are compensation for services or payments for the sale of a patent or other capital asset stems from the fact that an invention is merely the fruit of the inventor’s labor, and that the payment for the invention itself necessarily compensates the inventor for his services in creating the invention.”).
72. Rev. Rul. 64-56, 1964-1 C.B. 133.
73. *Id.* at 134.
74. Rev. Proc. 69-19, 1969-2 C.B. 301.
75. *Id.* Rev. Proc. 69-19 sets forth a number of factors that will be considered in determining whether the information will be characterized as know how, including (1) whether the information is revealed by patent or is the subject of a patent application or is disclosed by the product in which it is used or related to, (2) whether the information represents mere knowledge, or efficiency resulting from experience, (3) whether the information involved is merely the rights to tangible evidence of information such as blueprints, drawings or other physical material, and (4) whether the information has been developed especially for the transferee.
76. Rev. Rul. 64-56 at 134. Revenue Ruling 64-56 provides as an example of such ancillary and subsidiary services those that are performed “in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective ‘start-up’ of the property transferred, or by performing under a guarantee relating to such effective starting-up.” *Id.*
77. *Id.* at 134-35 (“Training the transferee’s employees in skills of any grade through expertness, for example, in a recognized profession, craft, or trade is to be distinguished as essentially educational and, like any other teaching services, is taxable when compensated in stock or otherwise, without being affected by section 351 of the Code.”).
78. *Id.* at 134.
79. 378 F.2d 595 (5th Cir. 1967).
80. *Id.* at 599.
81. *Id.* at 596-98.
82. *Id.* at 599-600.
83. See *PPG Industries, Inc. v. Commissioner of Internal Revenue*, 55 T.C. 928, 1014 (1970) (finding that “the transfer of unpatented technology under each of the four agreements was for a fixed period of years and that such transfers did not convey all substantial rights in the subject matter covered by the agreement,” but failing to provide any analysis of why the technology potential qualifies for treatment under Section 1235 by analogy); *Kaczmarek v. Commissioner of Internal Revenue*, T.C. Memo. 1982-66 (1982) (noting that while “the treatment of payments as to unpatented inventions, technical data, secret processes, and trade secrets is not specifically covered by statute, it is nevertheless “settled, however, that transfers of unpatented technology are treated for tax purposes in a manner akin to that afforded transfers of patents”). In *Glen O’Brien Movable Partition Co., Inc. v. Commissioner of Internal Revenue*, 70 T.C. 492, 502-03 (1978), the Tax Court came closest to applying the analysis of know-how developed for purposes of Section 351 under an “all substantial rights” consideration, noting that “[k]now-how which is either secret or which is transferred incident to the transfer of patents is ‘property’ for purposes of sections 1221 and 1231” and applying the “all substantial rights” analysis to the transfer of know how.
84. Section 1253(a).
85. Section 1253(b)(2).

86. Section 1253(c).

87. This confusion is exemplified in the “Dairy Queen cases,” a series of five cases with similar facts regarding the transfer of rights to the Dairy Queen franchise in five different jurisdictions. See *Dairy Queen of Oklahoma v. Commissioner of Internal Revenue*, 250 F.2d 503 (10th Cir. 1957); *Estate of Gowdeny v. Commissioner of Internal Revenue*, 307 F.2d 816 (4th Cir. 1962); *Moberg v. Commissioner of Internal Revenue*, 305 F.2d 800 (5th Cir. 1962); *Moburg v. Commissioner of Internal Revenue*, 305 F.2d 800 (9th Cir. 1962); *Wernentin v. Commissioner of Internal Revenue*, 354 F.2d 757 (8th Cir. 1965). Three of the circuits treated the transfers as a sale of a franchise even though certain restrictions were placed on quality control and product line, and two of the circuits found the transfer to be more in the nature of a license. There was also little consistency among the circuits with respect to the treatment of contingent payments, with some of the jurisdictions treating the contingent payments as part of the sale of a capital asset, and some separating out the contingent payments as ordinary income.

88. William M. Shaheen, *Tax Planning for the Transfer of Franchises, Trademarks, and Trade Names*, WG&L, v. 28, no. 03, May/June 2001.

89. In the vast majority of cases, both courts and the IRS respect the form and substance of the agreements that embody the transfer. Because most such transfers involve licensing agreements, once it is determined that the transferor retained significant rights in the transferred trademark, trade name or franchise, the court or IRS simply treats the transfer as the grant of a non-exclusive license, consistent with the terms of the transfer document, rather than the sale or exchange of a capital asset. See, e.g. *Syncsort Incorporated v. U.S.*, 74 AFTR 2d 94-5034 (1994) (transfer of certain franchises in which transferor retained significant rights under Section 1253(b)(2) was the transfer of a license that did not qualify for capital gains treatment); *Stokely USA, Inc. v. Commissioner of Internal Revenue*, 100 T.C. 439 (1993) (transfer of trademarks and trade names where the transaction was embodied in a license agreement was treated as the grant of a license).

90. Section 1221(a)(3) excludes from the definition of capital asset a copyright held by “(A) a taxpayer whose personal efforts created such property, (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).”

91. Section 1221(a)(3)(C).

92. Treas. Reg. § 1.1221-1(c)(1).

93. Treas. Reg. § 1.861-18(a)(2). Treas. Reg. § 1.861-18(a)(3) defines a computer program as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.” The program includes “any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.”

94. Treas. Reg. § 1.861-18(b)(1). If a transaction involves the transfer of more than one of these, then each part will be treated as a separate transaction. Treas. Reg. § 1.1861-18(b)(2).

95. Treas. Reg. § 1.1861-18(c)(1)(i) and 1.1861-18(c)(2).

96. Treas. Reg. § 1.1861-18(c)(1)(ii) and 1.1861-18(c)(3).

97. Treas. Reg. § 1.1861-18(e).

98. Treas. Reg. § 1.1861-18(f)(1).

99. *Id.*

100. Treas. Reg. § 1.1861-18(h), Example 5.
101. 419 F.3d 554 (6th Cir. 2005).
102. *Id.* at 555.
103. *Id.* at 558.
104. *Id.*
105. *Id.* at 556.
106. *Id.*
107. *Id.*
108. *Id.* at 556-57.
109. *Id.* at 558.
110. Payments made pursuant to the Distribution Agreement Vision were made based upon a fee schedule attached to the agreement. Payments made under the License Agreement were referred to in the agreement as licensing fees. *Id.* at 558.
- 111 *Id.* at 558-59, citing *Pickren V. United States*, 378 F.2d 595 (5th Cir. 1967).
- 112 *Id.* at 559.
- 113 *Id.*
- 114 *Id.* at 560.
- 115 *Id.* at 561.

Authors



Attorney Peter T. Beach is a member and director of the Manchester law firm of Sheehan Phinney Bass + Green, P.A., and is head of the taxation practice group. His practice covers a broad range of sophisticated tax matters.



Attorney Christopher J. Hamlen is an associate in Sheehan Phinney Bass + Green's corporate group. He practices primarily in the areas of general corporate law, mergers and acquisitions and securities regulation.