

**Taxation
of
Intellectual Property**

**Jeffrey A. Maine
University of Maine School of Law
Portland, Maine**

**Prepared for
16th Annual Advanced Licensing Institute
Franklin Pierce Law Center
January 10, 2008**

Part I:
Hypothetical Scenarios Related to Patent Development, Acquisitions, and Transfers

Hypothetical 1:	Patent Development
Hypothetical 2:	Patent Development
Hypothetical 3:	Patent and Domain Name Acquisition
Hypothetical 4:	Trade Secret Acquisition
Hypothetical 5:	Patent Acquisition
Hypothetical 6:	Patent Acquisition
Hypothetical 7:	Software Transfer
Hypothetical 8:	Patent Transfer
Hypothetical 9:	Patent Transfer
Hypothetical 10:	Patent Transfer
Hypothetical 11:	Patent Transfer
Hypothetical 12:	Patent Litigation
Hypothetical 13:	Patent Litigation
Hypothetical 14:	Patent Litigation
Hypothetical 15:	Intellectual Property Holding Company
Hypothetical 16:	Patent Donation to Charity

Part II:
Current Tax Issues in Patent Development and Technology Transfers

- I. Taxation of Patent Development
 - A. I.R.C. § 41
 - 1. The “Discovery Test”
 - 2. Patent Safe Harbor
 - 3. “Process of Experimentation”
 - 4. The “Substantially All” Requirement
 - 5. Section 41 Versus Section 174
 - B. I.R.C. § 59
 - C. I.R.C. § 174
 - D. I.R.C. § 263

- II. Taxation of Patent Transfers
 - A. Taxability of Patent Royalties
 - B. I.R.C. § 1235
 - 1. Employee Transfers
 - 2. “Holder” Status

- III. Charitable Donations of Patents
 - A. American Jobs Creation Act of 2004
 - B. Initial Tax Deduction
 - C. Future Tax Deductions
 - D. Impact of New Law

I. Taxation of Patent Development

A. **I.R.C. § 41.** In January 2004, after considering comments received and statements made at a public hearing, the Treasury issued final regulations under § 41. T.D. 9104, 69 Fed. Reg. 22-01 (Jan. 2, 2004). The final regulations are effective for taxable years ending on or after December 31, 2003. Treas. Reg. § 1.41-4(e). For taxable years ending before December 31, 2003, the IRS will not challenge tax return positions consistent with these final regulations. Preamble, 69 Fed. Reg. 22, 26. These final regulations generally retain the provisions of the December 2001 proposed regulations, but clarify the provisions relating to the “process of experimentation” requirement in § 41(d)(1)(C). It should be noted that the final regulations do not contain final rules for research with respect to internal use software for purposes of § 41(d)(4)(E). Preamble, 69 Fed. Reg. 22. As a result, taxpayers can rely on the prior suspended regulations (issued in January 2001) or the proposed regulations (issued in December 2001) for research with respect to internal use software until final regulations are issued governing internal use software.

1. **The “Discovery Test.”** Prior to issuance of the final regulations in 2004, the controversial “discovery test,” or some form of it, had been used frequently by the IRS and several courts to disallow research credits, even though it was based on a strained interpretation of the statutory language of § 41(d) and lacked support in the legislative history. *See United Stationers Inc. v. U.S.*, 982 F. Supp. 1279 (N.D. Ill. 1997), *aff’d* 163 F.3d 440 (7th Cir. 1998). For more recent cases, see *Tax and Accounting Software Corp. v. U.S.*, 301 F.3d 1254 (10th Cir. 2002) (holding that there is an independent discovery requirement (test) in the multi-part test for research credit eligibility that must be satisfied before expenses can qualify for the research credit); *Wicor, Inc. v. U.S.*, 116 F. Supp.2d 1028 (E.D. Wis. 2000), *aff’d* 263 F.3d 659 (7th Cir. 2001); *Norwest Corp. and Subsidiaries v. Commissioner*, 110 T.C. 454 (1998). In a welcomed development, the final regulations issued in 2004 put to rest the controversial “discovery test” and eliminated the requirement that qualified research be undertaken to “obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering” Preamble, 66 Fed. Reg. 66363. Instead, the final regulations repeat the requirement from Treas. Reg. § 1.174-2(a)(1) by stating 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. *Id.* According to Treas. Reg. § 1.174-2(a)(1), “uncertainty” exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. As stated in the Preamble, “there should be no ‘discovery’ requirement in the research credit regulations separate and apart from that already required under § 1.174-2(a)(1).” Preamble, 66 Fed. Reg. 66363.
2. **Patent Safe Harbor.** As under the prior suspended regulations, the final regulations provide a patent safe harbor, under which the issuance of a patent is conclusive evidence that a taxpayer has discovered information that is

technological in nature and is intended to eliminate uncertainty concerning the development or improvement of a business component. Treas. Reg. § 1.41-4(a)(3)(iii). The patent safe harbor has not been extended to encompass the process of experimentation requirement, discussed below. Accordingly, some commentators have questioned what purpose the patent safe harbor serves given that the regulations abandon the discovery test. See Christopher J. Ohmes, David S. Hudson, & Monique J. Migneault, *Final Research Credit Regulations Expected to Immediately Affect IRS Examinations*, TAX NOTES, Feb. 23, 2004, at 1015, 1018.

3. **“Process of Experimentation.”** The final regulations issued in 2004 provide that “a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer’s research activities.” Treas. Reg. § 1.41-4(a)(5). In contrast to the prior suspended regulations, the final regulations provide that activities to establish the appropriate design of a business component may qualify for the credit. *Id.* The final regulations set out the core elements of a process of experimentation for purposes of the research credit:
 - a. A taxpayer is required to identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer’s research activities.
 - b. A taxpayer is required to identify one or more alternatives intended to eliminate that uncertainty.
 - c. A taxpayer is required to identify and conduct a process of evaluating the alternatives (e.g., modeling, simulation, or systematic trial and error).

As continues to be clear, the requirements for a process of experimentation under § 41 continue to be more stringent than the requirements for research and development in the experimental or laboratory sense under § 174. Indeed, the final regulations state that the mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer’s activities undertaken to achieve the new or improved business component constitute a “process of experimentation,” even if the taxpayer does achieve the new or improved business component. Treas. Reg. § 1.41-4(a)(5)(I). And, as stated in the Preamble, “merely demonstrating that uncertainty has been eliminated (e.g., the achievement of the appropriate design of a business component when such design was uncertain as of the beginning of a taxpayer’s activities) is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement.” Preamble, 69 Fed. Reg. 22, 24.

4. **The “Substantially All” Requirement.** As with the prior suspended regulations, the final regulations issued in 2004 provide that the “substantially all”

requirement is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistent reasonable basis, constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality of a business component. Treas. Reg. § 1.41-4(a)(6). The final regulations clarify that the “substantially all” requirement can be satisfied even if some portion of a taxpayer’s activities are not for a qualified purpose (e.g., relating to style, taste, cosmetic, or seasonal design factors). *See id.*; *see also id.* § 1.41-4(a)(8), Example 4.

- 5. Section 41 Versus Section 174.** It might be possible for research expenses to qualify for the credit under § 41 as well as the deduction under § 174. In such a case, to the extent a credit is taken under § 41, deductions under § 174 must be reduced pursuant to § 280C. I.R.C. § 280C(c)(1). Even if deductions are not taken under § 174, but rather are capitalized, the amount capitalized must be reduced by the amount of any research credit under § 41. I.R.C. § 280C(c)(2). It should be noted that a taxpayer can elect to claim a reduced research credit under § 41 and thereby avoid a reduction of the § 174 deduction. I.R.C. § 280C(c)(3). The IRS and Treasury have requested public comment on regulations relating to the manner of making this election under § 280C(c)(3). 69 Fed. Reg. 21600-21601 (Apr. 21, 2004).
- B. I.R.C. § 59.** On July 19, 2004, the Service published proposed regulations on the optional 10-year write-off of research and experimental expenditures. Prop. Reg. § 1.59-1, at 69 Fed. Reg. 43367-43369 (July 19, 2004). Effective for tax years ending on or after July 20, 2004, the regulations provide guidance for making and revoking elections under § 59(e). Many commentators have criticized the proposed regulations for imposing onerous documentation requirements.
- C. I.R.C. § 174.** The Tax Court recently addressed whether research and development expenditures incurred by a computer software developer were incurred in a trade or business and, thus, deductible under § 174. In *Saykally v. Commissioner*, T.C. Memo 2003-152, the taxpayer, who had extensive technical expertise in the computer software industry, entered into an agreement with his wholly-owned corporation, which was engaged in the marketing of software products. Under the agreement, the taxpayer would create and own developed technology and would license the developed technology to his wholly owned corporation in exchange for royalties. The corporation would market the developed technology to its customers. The taxpayer deducted his research and development expenditures on his tax return. The IRS disallowed the deductions on the ground that they were not incurred in a trade or business. The Tax Court held that the software developer was not entitled to current deductions under § 174. According to the court, the taxpayer did not intend to market the developed technology himself, but rather intended to market the technology through his wholly-owned corporation. The taxpayer did not have the objective intent to enter into a future business of his own with the developed technology. Rather, the taxpayer’s purpose for engaging in the software development was to create the developed technology that could be licensed to the corporation for use in the corporation’s existing business. In other words, the taxpayer’s

research and development activities amounted to nothing more than the development of property rights that he intended to license to another company for use in that company's trade or business.

- D. I.R.C. § 263.** In January 2004, the Service issued final regulations under § 263 that provide comprehensive rules for capitalization of amounts paid to acquire or create intangible assets. *See* T.D. 9107, 68 FR 436-01. The final regulations adopt with some minor revisions the proposed regulations that were issued in December 2002. The final regulations apply to amounts paid or incurred on or after December 31, 2003. Treas. Reg. § 1.263(a)-4(o).

II. Taxation of Patent Transfers

- A. Taxability of Patent Royalties.** A claim for more royalties from a licensee has no bearing on the taxability of royalties actually received. *See Poindexter v. Commissioner*, T.C. Memo 2005-122 (holding that a licensor's claim that he should have received more royalties (i.e., claim that he was not paid the full royalties owed by a licensee) has no bearing on determining the licensor's correct tax liability and his obligation to pay that liability).
- B. I.R.C. § 1031.** In Technical Advice Memorandum 200602034 (Sept. 29, 2005), the IRS provided guidance on intellectual property exchanges. The IRS ruled that intellectual property used predominantly in the United States and intellectual property used predominantly outside the United States are not "like-kind" property for purposes of nonrecognition treatment under § 1031. For two patents to be considered of like kind, the IRS ruled that the underlying property must be either of the same General Asset Class under Treas. Reg. § 1.1031(a)-2(b)(2) or the same Product Class of § 1.1031(a)-2(b)(3) or otherwise of like kind. The IRS applied the same analysis to unregistered intellectual property (i.e., designs and drawings, trade secrets and secret know-how). The IRS also ruled that trademarks and trade names should never be considered like-kind because trademarks and trade names are unique and so closely related to (if not part of) the goodwill and going concern value of a business.
- C. I.R.C. § 1235.** The Internal Revenue Service has recently issued several administrative pronouncements dealing with Section 1235 of the Internal Revenue Code:
- 1. Employee Transfers.** In a recent Technical Advice Memorandum, the IRS applied *McClain* and *Chilton* in concluding that a university professor was entitled to capital gains treatment under § 1235 for royalties received from the university. In Tech. Adv. Mem. 200249002 (Aug. 8, 2002), a university professor developed an invention in the course of his research. He filed patent applications for the invention and then executed an assignment agreement, assigning his interest in the patent applications to the university. The professor also entered into a royalty distribution agreement with the university regarding the invention, which provided the professor would receive a certain percentage of the royalties

resulting from the university's licensing of the patents. The university treated these amounts as royalty payments and not as part of the professor's salary. In the TAM, the Service looked to the facts and circumstances of the employment relationship and concluded that the payments in question were connected to the transfer of invention rights, rather than compensation for services. Among the factors considered in favor of the professor were: (1) The payments received for the rights to the invention were in addition to and separate from the professor's salary, pursuant to a separate agreement with the university; (2) continued receipt of the payments was not contingent on continued employment with the university, (3) the amount of the payments received was dependent on the use or value of the licensing of the patent, and (4) the university treated the payments as royalties, not as salary.

2. **“Holder” Status.** In 2005, the Service issued three private letter rulings holding that an inventor who filed patents with two co-inventors and formed a limited liability company (LLC) with them retained his status as a “holder” for purposes of §1235, and that any gain recognized by the LLC on disposition of the patent rights would be qualified for treatment as preferential long-term capital gain to the members. Priv. Ltr. Rul. 200506008; Priv. Ltr. Rul. 200506009; Priv. Ltr. Rul. 200506019. In these rulings, three inventors (A, B, and C) filed several patent applications relating to a certain product. In a tax-free transaction, they transferred their respective interests in the product (including all of their interest in the patents and trade secrets, know-how, and other intellectual property associated with the product) to a newly formed LLC (treated as a partnership for tax purposes) in exchange for membership interests in the LLC. In response to a ruling request by Investor A, the Service concluded: (1) following the transfer of A's interests in the patents to the LLC, A will retain A's status as a “holder” for § 1235 purposes; and (2) provided the other requirements of section 1235 were satisfied, A's allocable shares of gain recognized by the LLC on a disposition of an interest in the patents would qualify under § 1235 as long-term capital gain.

III. Charitable Donations of Patents

- A. **American Jobs Creation Act of 2004.** On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (“the 2004 Act”). The 2004 Act is intended to curb improper deductions resulting from overvaluation, while continuing to encourage donations of intellectual property to qualified charities. The new legislation applies to all forms of intellectual property, including patents, certain copyrights, trademarks, trade names, trade secrets and know-how, certain software, or similar intellectual property or applications or registrations of such property. The new legislation does not apply to self-created copyrights or off-the-shelf computer software.
- B. **Initial Tax Deduction.** The 2004 Act limits the amount of the charitable deduction to the lesser of the taxpayer's basis in the donated intellectual property or the fair market value of the intellectual property at the time of the contribution. I.R.C. § 170(e)(1)(B). In most cases, the lesser amount would be the donor's basis.

C. Future Tax Deductions. Although the 2004 Act lowers the initial charitable deduction, it permits a donor to take additional charitable deductions in later years based on a certain percentage of the donee’s income attributable to the intellectual property. More specifically, a donor is allowed additional deductions in later years based on a specified percentage of the “qualified donee income” received or accrued by the charity from the donated property itself, rather than income stemming from the activity in which the donated property is used. I.R.C. § 170(m)(3). “Qualified donee income” is the net income that is properly allocable to “qualified intellectual property.” For purposes of these future deductions, “qualified intellectual property” does not include intellectual property donated to a private foundation. I.R.C. § 170(m)(9).

The amount of the additional deduction a taxpayer may take each year is determined using a sliding-scale percentage of qualified donee income received or accrued by the charity that is allocable to the property. I.R.C. § 170(m)(1), (7). As illustrated below, the percentage decreases each year over a twelve-year period. In the first and second years after the contribution, a taxpayer can deduct 100% of the qualified donee income. In year three, a taxpayer may deduct 90% of the qualified donee income. In year ten, only 20% of the qualified donee income is deductible. The following chart shows the actual sliding scale:

Taxable Year of Donor Ending on or After Date of Contribution	Applicable Percentage
1st.....	100
2nd.....	100
3rd.....	90
4th.....	80
5th.....	70
6th.....	60
7th.....	50
8th.....	40
9th.....	30
10th.....	20
11th.....	10
12th.....	10

D. Impact of New Law. By eliminating the fair market value standard for contributions of intellectual property, the 2004 Act will reduce the number of negligent and intentional overvaluations of intellectual property donations and, correspondingly, will reduce the administrative costs and burdens associated with overvaluations of donated intellectual property. By eliminating a fair market value approach, however, the 2004 Act has eliminated the immediate economic incentive for charitable giving of intellectual property. Without this immediate economic incentive, according to some commentators, donations of intellectual property will decrease dramatically.