

# INTELLECTUAL PROPERTY TAXATION

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# A PATENTAX® PRESENTATION

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## I. Introduction

Beginning in 2013 the capital gains rates above the zero bracket were split into two (15% and 20%) and the Obamacare surtax at 3.8% were added into federal tax rates. Before 2013, sellers of capital assets only had to worry about a separate flat 15% capital gains tax rate alongside a progressive (aggressive) income tax rate, and for sale of an asset the seller (as a practical matter) only needed to consider the amount times the single flat 15% capital gains tax rate. Under the new tax scheme, the capital gains rate and Obamacare surtax rate depend upon total income. In other words, the capital gains rate paid will depend upon a taxpayer's overall income from other, especially ordinary, sources.

Further, the top Federal Income tax rate rose from 35% to 39.6%.

In addition, in November 2012, California passed Proposition 30 raising the top marginal California Tax rate to 13.3% making it the highest in the nation. This change was retroactive to begin on January 1, 2012, and thus the combination of both tax increases for California Inventor patent seller occurred over about a month.

For Tax year 2012 (compared to 2011) the combined effect of the state increase driving the top marginal tax rate for a California Inventor that sells his invention from 24.3% (15%+ 9.3%) in 2011 to 28.3% (15%+ 13.3%) in 2012. This is an increase of 4% over the previous 9.3% rate but occurring over only a months time.

For 2013, the changes to the federal rate made a further combination effect of driving the top marginal tax rate for a California Inventor that sells his invention from 28.3% (15%+13.3%) in 2012 to 37.1% (20%+ 3.8%+13.3%) in 2013. This is an in-state increase of 8.8% over the previous 4% increase for 2012 bringing the total tax increase for difference for California Inventor that sells his invention to 12.8% in the period between November 2012 and January 2, 2013.

The top marginal tax rate for "non-sale", but passive royalties for the California Inventor that licenses his invention, exclusively or non-exclusively will have risen in two years from 44.3% (35%+ 9.3%) in 2011 to 63.4% (39.6%+20%+ 3.8%) in 2013, a tax increase of 19.1% !

The charts at the end of the outline have been adjusted and show more detail.

## II. Understanding the Negative Nature of IP

### A. Common Misconceptions

#### 1. Patents

- (a) “If I have a patent I have the right to manufacture” - NO
- (b) “I have to do a search so I can know all that’s out there”
- (c) “Can I get an “INTERNATIONAL PATENT”?”

#### 2. Trademarks

- (a) “But if the name people don’t know what the product is by reading the trademark, what good is it?”
- (b) “Hey, lets use the same trademark that ‘big corp’ has but we can change one letter and they can’t touch us”

#### 3. Copyright

- (a) “I made this clothing by hand, I want to copyright it”
- (b) “Will you take my case on contingency, I don’t believe in my copyright THAT much and I don’t want to pay anything if I lose”

#### 4. General

- (a) “Send them a really nasty infringement letter, if they don’t like it, they can lump it”
- (b) “We just received a letter accusing us of infringement, but they are not serious until they bring a lawsuit.”
- (c) I just won this big judgment for 6 years worth of infringement, the money is capital gains, right?

## III. Overview of Intellectual Property Categories

### A. COPYRIGHT

1. Copyright, like all other forms of intellectual property, is based on negative rights. A copyright registrant may exclude others from reproducing a given copyrighted work, composing a derivative work, performing the work publicly, distributing the work (including sale, lease, or rental of the work), or displaying the work. Works that may be protected by copyright include literary works; musical works and accompanying words; audiovisual works, including motion pictures; sculptural works; pictorial, graphic and architectural works; sound recordings; and, pantomimes and audiovisual works.
2. The power of copyright is especially effective in preventing the rote copying of a work. A work is a fixed, complete form of authorship. To be complete, a work must have all of its component parts. A computer program which does not run and has no utility is a good example of an incomplete project that is not a work. Direct copying is the easiest form of copyright infringement activity to prevent. However, the test in copyright is one of substantial similarity. Whether a copied work is substantially similar to the copyrighted work is a question of fact to be decided by a jury.
3. Rights conferred to a copyright registrant can be retained or licensed as the copyright registrant sees fit. For example, a license agreement may be crafted based on the registrant’s rights.

License agreements can be as broad and open as any contract and can require a licensee to pay money or perform other duties in exchange for the license. The ability to exclusively perform the work is especially important for playwrights who receive royalties, not only from the publication of their plays, but also from the performance of their plays.

4. Certain areas of copyright law are rife with traps for the unwary copyright registrant. First, a work must rise to a minimum level of originality to be considered copyrightable. For example, data works such as columns of raw information may be so lacking in authorship as to be considered unregistrable. Similarly, designs which only include basic geometric forms may also be held unoriginal. Generally speaking, the more complex a work is, the more likely it is to be considered original in terms of authorship.
5. Another area of copyright that may present problems is that of works for hire. Works for hire include works done as a non-contract employee and contributions to a larger collective work, such as a movie. Where a party pays to have a work performed but neglects to clearly specify who the owner of the completed work will be, problems are certain to arise. We strongly advise that those seeking to hire authors, designers, and the like, should not only contract for the work to be done, but should ensure that the contract explicitly sets forth who the owner of the completed work will be. Collective works present another set of problems because all contributing authors must give their permission for use of their constituent parts. The creativity which is applied to organize the parts making up the whole is also protectible by copyright.
6. Joint works also create potential problems for copyright registrants. Where a work is prepared by two or more authors who intend to merge their contribution into an inseparable whole, the US Copyright Office will treat each of the authors as having equal rights to register and enforce the copyright, and this holds true whether or not there are other agreements to the contrary between the registrants.
7. The duration of a copyright varies depending on the type of work for which protection is sought. In general, a work is protected for the life of the author plus 70 years (Sony Bono Copyright Term Extension Act). The exceptions to the rule include works for hire, anonymous works, and pseudo anonymous works, which are protected for 95 years from the first publication or 120 years from the year of creation.
8. Copyright notice can be communicated in a number of different ways. The most common forms of notice include the “circle C” symbol or the word “copyright” in full or abbreviated form, as well as the first year of publication and name of the copyright registrant. After March 1, 1989, lack of copyright notice is not fatal, but including a copyright notice is advisable because (1) it lets others know that a work is protected by copyright, (2) it directs would-be users to the copyright registrant for permission to use the work, and (3) it precludes a defendant in a copyright infringement case from using the defense of “innocent infringer” because it serves as constructive notice of copyright, i.e., the defendant is considered to be aware of the copyright whether or not he actually saw the notice.

## B. TRADEMARK

1. A trademark is any word, name, symbol, device, or any combination thereof which is used in connection with goods or services to help consumers identify the source of those goods and services for the purpose of differentiating the goods and services from those of competitors.
2. Trademark rights accrue as to a given set of goods or services based upon the theory that successful name recognition will follow increasing quality and excellence. Trademark rights begin with the use of the trademark. For this reason, later users of a trademark can potentially be

- foreclosed from using a name. The scope of rights in a trademark depends upon how the mark is used. For example, the trademark EXXON is generally thought to be a coined mark, such that it would preclude any use by others, even where the use might be for non-petroleum goods and services. The scope of rights for other, lesser-known trademarks, is usually narrower than the scope of rights for coined marks, such that the use of the mark in one area will generally not prevent the use of the mark in other goods and service areas.
3. Use of a trademark is demonstrated with specimens that show how the mark is used with the goods. The best way to show trademark usage may be to impress the trademark directly upon the goods. Tags and labels applied to the goods are another proper way to use the trademark. However, it must be kept in mind that a use which is too greatly removed from a direct association with the goods may fail as a proper use.
  4. Because there are no "goods" upon which to affix a service mark, an advertisement is generally the only way to show a connection between a service mark and the services to be associated with the mark. Aside from the differences in which the use is shown, the application and examination procedure is approximately the same.
  5. Note that there are two basic mechanisms for naming a business which have nothing to do with trademarks. The county designation "doing business as," or DBA, and the state corporate filing are both employed to insure that there will be a responsible entity doing business in the county or state, and that the responsible entity is distinguishable from other entities. These designations help to be sure that no two entities have the same name either locally or on a statewide level.
  6. Therefore, the steps necessary for acquiring a federally registered trademark are generally as follows:
    - (a) Select the mark using the following guidelines:
      - % Pick a word that is NOT in a dictionary (of any language, but especially English);
      - % Pick a word that is NOT similar to any trademark word of someone else;
      - % Pick an UNUSUAL, DISTINCTIVE word;
      - % Pick a word that is NOT a person's last name;
      - % Pick a word that is NOT descriptive (IN ANY WAY WHATSOEVER) of the goods or services which will be associated with the trademark or service mark. (Note: The PTO is strict on this point, and even if you get a mark with descriptive aspects past the PTO, a descriptive mark is likely to cost you precious, hard-earned profits in the long run);
      - % Pick a word that does NOT end/conclude with a descriptive noun;
      - % Pick a word that excludes all descriptive words;
      - % Pick a word that is not geographic; and.
      - % Pick a word that is not scandalous, vulgar, derogatory, etc.
    - (b) Use the mark properly in interstate commerce (generally in public business)
    - (c) Apply for federal registration of the mark
      - % PTO may examine the application in about 1 year
      - % PTO will publish the potential mark to give an opportunity for members of the public to oppose registration of the mark
      - % Registration of the mark will occur in approximately 6 months after publication, assuming no opposition was filed or, if an opposition was filed, assuming it was not successful
      - % First renewal is due after 5 years continuous use (§8)
      - % The mark becomes incontestable after 5 years of use (§15)
      - % Duration of the trademark protection (i.e., actual ownership) extends for 10 years

after first renewal  
% These selection rules dominate the tax treatment in future years.

7. In the tax section of this outline, it can be seen that the above selection rules can be critical in having a successful outcome for trademark.
8. As you can see, from the first use, incontestability can be achieved in about 6 years from application (assuming no problems during the application process. Many things can stop the process, including a rejection by the Examiner, an opposition filed by another who believes he will be damaged by your registration, a petition to cancel the registration from others, and worst of all, forgetting about the trademark and allowing it to lapse by failure to file the §8 & §15 affidavit.
9. One possible way to think about trademark in the U.S., as a general construct, and will bend the mind of anyone who believes that trademarks are like some sort of “permit” that you purchase and keep forever, is the boiling down of trademark, if it were possible, which it is not truly possible, but which might be imaged as involving but two rules:  
Rule 1: First substantial federal user wins;  
Rule 2: A trademark owner who obtains registration + 5 years of usage, cuts off the priority rights of a trademark owner of Rule 1. (incontestability)  
The trademark system is more complicated than this, as it includes matters of trade dress, palming off, special rules on sourcing of geographic products of origin, etc., but thinking this way will aid in realization that the most important ownership event in the life of a regular trademark is the achievement of incontestability.

## C. TRADE SECRET

1. A trade secret is considered to be any information (including a formula, pattern, compilation, program, device, method, technique or process) which (1) derives independent economic value (actual or potential) from not being generally known to the public or to other persons who could obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.
2. It is illegal to acquire a trade secret of another where the acquiring person knows or has reason to know that the trade secret was obtained by improper means. Improper means include theft, bribery, misrepresentation, breach or inducement of breach of a duty to maintain secrecy, or espionage through electronic or other means. Reverse engineering or independent derivation alone is generally not considered improper means. There is also a companion definition in the penal code which makes trade secret theft a felony.
3. Whether a trade secret has been truly protected is not merely a question of whether it was kept secret; the systematic steps and procedures taken to keep it secret are crucial to the determination of protection. Evidence of locking doors, assigning keys, and segregating personnel based on a need to know will be dispositive in determining whether one has acted to protect secret a trade secret.
4. This area of law cuts a fine distinction where control of people is concerned. One’s ability to use the knowledge gained from an employer is distinguishable from one’s right to use one’s skills and knowledge, apart from the specifics of the trade secret, in a specialized area. These factors are carefully weighed by the courts, especially where the secret is related to the specialized area of knowledge.

5. Generally, patents start out as trade secrets between the time that they are formulated and until they are written up and filed as a patent application. As will be seen, the tax treatment of trade secrets can, depending upon how it is structured, be equivalent to patents with a further adjustment of surrender of further rights to create a sale.

#### D. PATENT

1. There are generally three kinds of patents: design, plant, and utility. Design patents protect the way something looks, e.g., the look of an automobile, a computer, a pair of tennis shoes, or a vacuum cleaner. Plant patents protect varieties of plants such as orchids, roses, flowers, and other agricultural plants. Utility patents provide protection for things and the way they work, e.g., circuits, machines, chemicals, and processes.
2. Patentable subject matter includes machines, processes, compositions of matter, articles of manufacture, software and computer processes.
3. Two common categories into which utility patents fall are (1) process and apparatus for practicing a process, and (2) compositions of matter and processes involving compositions of matter. A new, unexpected use for an old, known composition of matter can qualify for a patent. An apparatus and process steps for use of the apparatus are generally intertwined; therefore, new uses for an old machine are rarely patentable.
4. Traditionally, the copyrighting of software was an accident resulting from a characterization of the early programming as language rather than machine setting. As a result, computer programs began under the characterization of language composition and thus copyright. Eventually software came to be seen as dual recognition matter, with copyright protecting the style of program writing and patent protecting a programmed machine step. Even as the Supreme Court spoke through the *Bilski* case there is still no concrete direction, except that Congress just dumped tax patents which were no threat anyway. After *Bilski*, the PTO still wants to see machine steps and its not exactly clear the extent to which business method patent are going to be allowed.
5. Software patentability has undergone a change over the past decade.
  - (a) In *State Street Bank & Trust v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), the U.S. Court of Appeals for the Federal Circuit (CAFC) held that (1) ALL software is patentable and (2) business methods are patentable. The rule that methods of doing business were not patentable had been in force for 100 years prior to this decision. This ruling has been accepted by the US Patent Office, and has been validated and expanded in subsequent rulings of the CAFC.
  - (b) Currently a case which has limited the patentability of some computer software has been decided by U.S. Supreme Court. *Bilski v. Kappos* 561 U.S. 8 (2010) held that the machine or transformation test is not the sole test for patent-eligible subject matter.
  - (c) A combination of the ire raised against tax patents as a form of business method patent (having gone too far) has prompted, and perhaps caused the timing of the change in the law from “first to invent” to “first to file” under the American Inventor’s Act which was implemented in September 2012 and March 2013. The legislation provided for an “overseer anti-business patent board” politely named a “Transitional Program for Covered Business Method Patents” The AIA specifies that a covered business method patent is a patent that claims a method or corresponding apparatus for performing data processing or other operations used in the practice, administration, or management of a financial product or service, except that the term does not include patents for

technological inventions.

- (d) With the biological arts the controversy over what is patentable leads to some newly articulated “laws of nature” language. In *Mayo Collaborative Services. v. Prometheus Labs. Inc.*, 566 U.S. \_\_\_ (2012), the U.S. Supreme court opined that “if a law of nature is not patentable, then neither is a process reciting a law of nature, unless that process has additional features that provide practical assurance that the process is more than a drafting effort designed to monopolize the law of nature itself.”
  - (e) It is believed that the changes in the patent law since 1999 have resulted from a wish “not to be left behind” from the changes in the patent law of Europe & Japan, yet alternatively trying to “rein-in” the outlandish problems that might result from a liberal interpretation of what may be patentable. The U.S. does not want the world to get ahead of it, but takes pains to try and trim the excess that might (and has) been brought along with such liberalization. Tax patents are an area in which I have written that they posed no danger and are not practically enforceable due to (1) confidentiality of tax returns, (2) the ability for the IRS to “outlaw” any procedures it didn’t agree with, and (3) the very negative association of anyone in the tax field who owned such patents with the IRS and Tax court, as well as the fear among clients of such patent owners that they would be singled out for audit. Put another way, having your taxes done by a licensee under the patent “marks” you for audit should the tax principles of the patent owner be found to be illegal or later held to be invalid. From the client’s perspective, why let yourself be ranked in the IRS’s patent technique audit categories?
  - (f) As a matter of interest, note that on August 28, 2013 that the nation of New Zealand banned software patents. New Zealand doesn’t want its people to be stopped in any way from “coding”.
6. The following results have gradually grown out of the State Street Bank decision:
- (a) The public policy blunder of having previously placed software under the tax-disadvantaged copyright protection domain is somewhat remedied by a substantial removal of software from the tax-disadvantaged categories. Consequently, software which embodies (novel and non-obvious) business methods, even if the business methods are suspect and subject to attack by the “Covered Business Method Patents” board, the tax benefits will likely not suffer much due to the time it takes for eventual holdings of patentable subject matter / nonpatentable subject matter and the lesser patentable / nonpatentable standard.
  - (b) Instant capital gains are still theoretically available for software creators under IRC §1235 if the software has a “chance” at patentability, and the IRS does not have the wherewithal to divine what is “potentially patentable” from what is “not potentially patentable”.
  - (c) Most software may now be expensed under IRC §174.
  - (d) Both patents and trade secrets result in instant capital gains under IRC §1235 for both creators and those in privity with creators before the invention is proven. Likewise, both patents and trade secrets allow for expensing and capitalization under IRC §174 for costs of creation and patenting activities.
  - (e) Generally, copyrighted material and associated software receive the most tax-disadvantaged treatment, including denial of capital asset status to creators, non-deductibility of creation costs, ordinary income on sale by the creator, and only



regular capital gains on resale once the asset leaves the purchaser's hands.

## 7. Effect of Dependence on Prior Law

- (a) Software and other works which have traditionally been considered “copyright-like” receive the following tax treatment: (1) such works are not capital assets in the hands of the creator; (2) development costs for such works may not be capitalized by the creator; (3) development costs for such works have previously not been expensable by non-creator payors (though this is not the case currently); (4) such works have a longer write-off period based upon the life of the author plus 70 years for general copyright, with some shorter write-off exceptions specific to software. As a result of these factors, and depending upon the type of business in which a taxpayer is engaged money earned will be ordinary income in any event.
- (b) Individual software creators/inventors are much more keenly affected by the ability to claim patent rights since the patent protection is much more powerful and tax-favored. Some of the commentators from the 1990s have commented that merely seeking copyright protection can result in the less favorable copyright-like tax treatment. There are some copyright deduction rules for off-the-shelf software, but immediate expensing under the patent tax rules are still preferable. Electing to capitalize a patent may only be logical where there is a net operating loss carry-forward that would be lost if one elected to expense the patent.
- (c) Expansion of the current controversy has continued along the same lines as the controversy between design patents and 3-D copyrights. The regulations take the view that if property is only protected under the patent laws, IRC § 1221(3) denying asset status will not apply. *Gilson v. Commissioner* states that if the taxpayer is not utilizing copyright laws, he should not be subject to harsher tax treatment. In the software area, the degree of dual protection is even greater, since patent protects a method, and a software copyright protects only the expression of the process in a specified language. However, licenses should be carefully drawn to distinguish these rights. This differs from the design and 3-D copyright dichotomy, where there is a bright line separation between the two areas based upon whether the item is utilitarian in nature.
- (d) As set forth below, the ability to write off development of software along the same lines as patent is now more clearly available. Tax treatment for sale of copyright remains grossly different from tax treatment for sale of patent by two primary factors: (1) sale of copyright by a creator results in ordinary income because a copyrighted work is not a capital asset, and (2) the waiting period for capital gains treatment on sale of copyright is one year, even where an individual purchases a copyright and can thus hold it as a capital asset.
- (e) Another recent case, *AT&T Corp. v. Excel Communications Inc.*, 98-1338 CAFC, has even further extended the patentability of software rule. Generally, this case stated that, so long as an algorithm is not usurped and so long as the claims are drawn to the algorithm in a USEFUL way, the algorithm may be patented. This change in classification of software is definitely here to stay.
- (f) There may be some confusion about the statement that “all software is now patentable”, as this statement merely means that all software is within the §101 definition of patentable subject matter. Thus, it is implied that perhaps only a small portion of software may actually be patentable. This may not matter from either a practical or a tax standpoint. To wit, you will recall that patents and trade secrets are treated the same from

a tax perspective; we believe the reason for this could be because the taxing authority was not interested in waiting years to determine whether an item was patentable. Additionally, an idea which is patentable is technically a trade secret until it is publicly disclosed. Because software is now treated no differently than other patentable matter, there is also no barrier to treating software as a trade secret.

- (g) For example: A software program in 2013 is very similar to one which was patented and published in 2012, i.e., it differs only by a few kinks and twists which are clearly trade secrets, but which do not rise to a level beyond the obviousness threshold. This software is a trade secret and is given the same benefits as if it were a patentable trade secret. Both the patentable and unpatentable versions of the software may be sold as trade secrets with corresponding capital asset treatment and instant capital gains under IRC §1235. Both may be the subject of a patent application (after all, the obviousness issue must be addressed by the examiner, and if the examiner rejects the claims in the final analysis, this may not occur until years later). Patent applications for both the patentable and unpatentable versions of the software may be the subject of an assignment within the Patent Office to show title, and either version may be the subject of an appeals process where there is a holding of non-patentability. Further, both applications may be the subject of later continuation-in-part applications which may include added details that result in patent issuance.
- (h) In summation, ultimate patentability based upon how good the invention is has never had anything to do with tax treatment. Conversely, the classification of subject matter as patentable or non-patentable has been crucial to tax treatment. For this reason, the mischaracterization of machine steps as copyrightable has always been problematic. With software patent and trade secrets looming on the horizon, we can only hope that the IRS stands ready with an intelligent position to avoid clogging the courts.

## 8. Patent Enforcement: Making the System Work

- (a) There are multiple considerations for the patentee who finds it necessary to actively enforce patent rights. Careful thought must be given to setting the tone of negotiations or licensing; crafting the notice of infringement; laches and estoppel; applying and maintaining pressure on infringers; ITC actions for imports; marshaling infringers to finance the action; and, acquiring patent insurance to cover suits against infringers as well as to insure against the possibility that a patent may be invalidated. It is of note that there are few companies which provide offensive patent insurance that may be used to pursue infringers. Intellectual Property Insurances Services Corporation has recently made available a policy for the loss of intellectual property value, and they may be contacted by mail at Suite 114, 10503 Timberwood Circle, Louisville, Kentucky 40223; by phone at 1-800-537-7863; or by e-mail at [info@infringeins.com](mailto:info@infringeins.com).
- (b) Value may be extracted from an issued patent by either (1) running a manufacturing operation as a monopoly, or (2) licensing other manufacturers to make the patented product. An exclusive license is a permission granted to a single manufacturer. A non-exclusive license may be granted to one or more manufacturers. The central difference between an exclusive and a non-exclusive license may lie in what actions are contractually assumed in the license if the patent is infringed. It is much more likely that an exclusive licensee will undertake to sue to protect the patent. Where there are non-exclusive licensees, the patent owner will generally be the one to undertake suit to protect the patent.
- (c) Patent holders who find themselves in the unfortunate position of accused infringer also

have multiple considerations. Intensive investigation and careful planning should ensue immediately: defensive insurance status should be determined; an opinion on patentability should be acquired; economic analysis should be performed as a prelude to potential licensing agreements; data on other potential infringers should be gathered; information damaging to the patent should be documented; and, a re-examination request may be in order where there is sufficient printed matter to support it.

## IV. Tax Treatment of Patents

### A. DEDUCTION OF DEVELOPMENT EXPENSES

1. In general, IRC §174(a) allows research or experimental expenditures to be treated as deductible expenses if they (1) are paid or incurred by a taxpayer during the taxable year, and (2) are in connection with the taxpayer's trade or business. The term "in connection with" is deliberately less stringent than the "ongoing business concern" requirement found in other sections of the code. For example, IRC §162 allows deductibility only for (1) ordinary & necessary expenses which are (2) paid or incurred in carrying on a trade or business. This would seem to indicate that a presently functioning business is a precondition of deductibility under IRC §162. Alternatively, IRC §174(b) allows expenses to be capitalized and amortized over a period of not less than 60 months; however, capitalization is typically only used to avoid losing carryover net operating losses from prior years. Although the "in connection with" language loosens the operation of IRC §174 appreciably, recent cases have applied what we refer to as an "in business of the invention" test, rejecting IRC §174 treatment for entities which are not intimately concerned with exploiting the technology. As a result, the inventor should be actively pursuing business or licensing with respect to the patent prior to taking advantage of deductibility under IRC §174. As yet another alternative, IRC §59(e) allows a taxpayer to capitalize and amortize over a 10 year period. This election can be made for separate projects, and regulations governing IRC §59(e) can be found at REG-124405-03.
2. In general, IRC §174 enables a taxpayer to deduct fees paid to a patent attorney to procure either a U.S. or a foreign patent. IRC §174 also allows a deduction for money spent on general research, as well as on product design, development, or improvement. However, to take advantage of the deduction for the cost of procuring a foreign patent, U.S. patent rights should already be in place (Rev. Rul. 68-471 1968-2 CB 109). Where a taxpayer has expenditures related to procuring foreign rights but does not own corresponding U.S. rights, the expenditures for the foreign patent are not likely to be deductible (Rev. Rul. 66-30, 1966-1 CB 55). Other non-deductible expenses include environmental impact studies and the cost of acquiring the patent of another. Also, relatively wealthy non-corporate taxpayers may be subject to the alternative minimum tax computation, which requires the expenditures to be capitalized and deducted ratably over 10 years (for alternative minimum tax purposes only). An exception to the alternative minimum tax capitalization is made where the taxpayer (materially participates) in the research and development as a business.
3. Note that there are dozens of tax cases relating to non-existent technology where individuals, particularly tax practitioners, sought to set up business models to enable investors to write off their "investment." In these cases, the IRC §174 write off (expensing treatment) is denied. In another line of cases, the "actively in business" test has been applied to deny IRC §174 treatment where the main investment vehicle was not immediately able to continue exploiting the technology or was not ready to take the technology elsewhere. We view this as a further expansion of the prohibition on purely investment partnerships, and a discussion of this line of cases is set forth after the discussion of the Green case below.

## B. CREDITS

1. IRC §41 gives taxpayers, typically large corporate taxpayers, a credit based upon either (a) a regular credit for qualified research expenditures which exceed some fixed base percentage of average annual gross receipts or (b) an incremental credit based upon (current) qualified research expenditures which exceed research intensity for a given base period. Although a percentage popularly stated with respect to this credit is “20%” there are other limitations to both credits which reduce the 20% value to a much lower figure. In the first case (regular credit) the 20% is applied to the lesser of 50% of the qualified research expenditure or the amount of qualified research expenditure above some percentage of last year’s gross receipts. In the second case (incremental credit) the 20% figure is multiplied times the EXCESS of qualified research expenditure over a somewhat complicated base period amount. The American Taxpayer Relief act of 2012 re-ser IRC §41(h) to cause this research credit to sunset after 2013.
2. The rules for what qualifies as “research expenditure” has been liberalized over the past few years and in some cases includes internal expenditure for software which will not be used outside the organization. For companies and individuals willing to crank through the computations and rules, the savings can be substantial. Several specialist companies have arisen that specialize in performing this specialized task for large integrated companies, taking a percentage of the tax savings for the specialist with enough left over for the use of the credit to remain lucrative for the companies that choose to take advantage of this provision.
3. To make matters worse, IRC §280C(c) disallows deduction of that portion of research expenses which are equivalent to the credit, while offering as an alternative the reduction of the credit (which would otherwise be completely lost under this complete take-away rule) of about 40% (taxpayer’s tax rate); i.e., the taxpayer gets to keep 60% of the an amount resulting less than the 10%-20% full credit. The taxpayer most in need of this provision is one who has undergone the burden of increasing research rapidly and in excess of normal gross income; unfortunately, this kind of taxpayer also has the greatest limitations on the credit, namely 60% times the 10% limited credit. Therefore, the best case scenario might well involve a poor taxpayer with a 0% tax rate who experiences a less than 50% increase in research and who can magically claim the full 20% credit!
4. The Pension Protection Act of 2006 (PPA) included a “simplified” research credit alternative more likely to impact small inventors in 2007:
  - (a) The prior and still effective research expense credit (claimed on Form 6765) equals the sum of: (1) 20% of any excess of qualified research expenses for the tax year over a **base amount**, (unless the taxpayer elects the alternative incremental credit, which would then replace this item); (2) The "university basic research credit," i.e., 20% of the basic research payments determined under Code Sec. 41(e)(1)(A); and (3) 20% of the taxpayer’s expenditures on qualified energy research undertaken by an energy research consortium. (Code Sec. 41(a)) .
  - (b) The **base amount** is a fixed-base percentage of taxpayer's average annual gross receipts from a U.S. trade or business, net of returns and allowances, for the four tax years before the credit year, and can't be less than 50% of the year's qualified research expenses. The fixed base percentage for a non-startup company that isn't using the alternative incremental credit is the percentage (not exceeding 16%) that taxpayer's total qualified research expenses is of total gross receipts for tax years beginning after 1983 and before 1989. Special rules apply to a “startup company” that has qualified research expenses. (Code Sec. 41(c)(3))

- (c) As a first alternative, taxpayers are allowed to elect an alternative incremental research credit regime in lieu of the regular research credit in which the taxpayer is assigned a three-tiered fixed-base percentage. (IRC § 41(c)(4)(A)) The new act increases the applicable percentages for the incremental credits. 2.65% rising to 3%, 3.3% rising to 4.0% and 3.75% rising to 5.0%
- (d) In a new alternative simplified research credit, a taxpayer can elect (in lieu of the 20% credit otherwise determined under Code Sec. 41(a)(1) ) a credit equal to 12% of the excess of the qualified research expenses for the tax year over 50% of the average qualified research expenses for the three tax years preceding the tax year for which the credit is being determined. (IRC § 41(c)(5)(A)). If a taxpayer has no qualified research expenses in any one of the three preceding tax years, the alternative simplified research credit is 6% of the qualified research expenses for the tax year for which the credit is being determined. (IRC § 41(c)(5)(B), as added by Act Sec. 104(c)(1)) .
- (e) California has a credit similar to the Federal Credit in structure, but only for research conducted within the state. Revenue & Tax Code §17052.12 (Personal Income Tax) and Revenue & Tax Code §23609 (Corporate Income Tax). [CA is stated to “conform to the federal research credit as it existed on January 1, 2001 (currently 12+ years ago!)... Compare Canada’s Federal 35% for the first \$3,000,000 invested (and 20% of amounts over \$3,000,000 ), as a refundable tax credit for research by Canadian Controlled Private Corporations (Internal Revenue Act §127(10.1)), along with supporting refundable tax credits from the provinces: Ontario (10% of qualifying Scientific Research & Experimental Development (SR&ED) expenses which may be 100% of current expenses and 40% of capital expenses-- Annual limit=\$300,000; Alberta (10%); British Columbia (10%); Manitoba (20%); New Brunswick (15%); Newfoundland and Labrador (15%); ; Nova Scotia (15%) ; Quebec (37.5%); Saskatchewan (15%); Yukon Territory (20%); Prince Edward Island, Nunavut & Northwest Territories (not stated)
- (f) The general trend these days is toward “Cost Segregation” a technique in which each element of expense is analyzed to see if it can fit into a credit category. Firms such as KBKG operate web sites offering free CPE to accountants and other tax professional to educate them about the technique. Expenses, if properly segregated, can result in a benefit which goes beyond the benefit of a mere deduction. In some cases a deduction may fit into several tax credit categories. Several firms have arisen making money by offering the service of optimizing a firms tax credit categories.

## C. CAPITAL GAINS TREATMENT ON THE SALE OF TECHNOLOGY

1. Just as a simple sale or exchange where the title to a patent is transferred, a domestic patent license which transfers all substantial rights in a patent is treated as a sale or exchange of the patent for tax purposes. Recall that capital gains are available under IRC §1235 (with both advantages and disadvantages), outside IRC §1235, or by sale of stock, etc., in the unfortunate circumstance where a patent has been assigned to a corporation. Although extremely ill-advised, this may be the case where venture capitalists are involved.
2. According to IRC §1235, which addresses the sale or exchange of patents. :  
 §1235(a)  
 GENERAL.- A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of such transfer are-
  - (1) payable periodically over a period generally coterminous with the transferee’s use

- of the patent, or
- (2) contingent on the productivity, use, or disposition of the property transferred.

3. Holder is defined in §1235 (b).  
§1235(b)

Holder Defined - For the purposes of this section, the term “holder” means-

- (a) any individual whose efforts created such property, or
- (b) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither-
  - (A) the employer of such creator, nor
  - (B) related to such creator (within the meaning of sub (d)).\*

My Note\*[members of a family, individual & 25% owned corporation, two corporations which are members of the same control group, grantor & fiduciary of a trust, and more. Constructive ownership of stock is limited to an individual's spouse, ancestors and lineal descendants] referencing (267(b), & 707(b).] Note that there are different rules for related taxpayers outside of §1235 (capital gains with an actual holding period).

4. Regulations under §1235 are seen as Reg. §1.1235:

1.1235 - 1 - Sale or exchange of patents.

(a) General rule. Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person other than a related person constitutes the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether or not payments therefor are: (1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or (2) Contingent on the productivity, use, or disposition of the property transferred.

(b) Scope of section 1235. If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

(c) Special rules

(1) Payments for infringement. If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. For taxable years beginning before January 1, 1964, see section 1304, as in effect before such date, and 1.1304A-1 for treatment of compensatory damages for patent infringement.

(2) Payments to an employee. Payments received by an employee as compensation for services rendered as an employee under an employment contract requiring the employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which section 1235 applies. However, 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) 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.

(3) Successive transfers. The applicability of section 1235 to transfers of undivided interest in patents, or to successive transfers of such rights, shall be determined separately with respect to each transfer.

For example, X, who is a holder, and Y, who is not a holder, transfer their respective two-thirds and one-third undivided interests in a patent to Z. Assume the transfer by X qualifies under section 1235 and that X in a later transfer acquires all the rights with respect to Y's interest, including the rights to payments from Z. One-third of all the payments thereafter received by X from Z are not attributable to a transfer to which section 1235 applies.

(d) Payor's treatment of payments in a transfer under section 1235.

Payments made by the transferee of patent rights pursuant to a transfer satisfying the requirements of section 1235 are payments of the purchase price for the patent rights and are not the payment of royalties.

(e) Effective date. Amounts received or accrued, and payments made or accrued, during any taxable year beginning after December 31, 1953 and ending after August 16, 1954, pursuant to a transfer satisfying the requirements of section 1235, whether such transfer occurred in a taxable year to which the Internal Revenue Code of 1954 applies, or in a year prior thereto, are subject to the provisions of section 1235.

(f) Nonresident aliens. For the special rule relating to nonresident aliens who have gains arising from a transfer to which section 1235 applies, see section 871 and the regulations thereunder. For withholding of tax from income of nonresident aliens, see section 1441 and the regulations thereunder.

Note: Be wary of these regs as they were introduced in 1960 and updated in 1966 & 1980.

5. During the tax years ending between 5/6/97 and 12/31/97, the capital gains were split into (1) a long term rate of 20% for holding periods over 18 months, and (2) a mid-term rate of 28% for holding periods over 12 months. The IRS issued a holding based on IRC §1235 which stated that the real intent was to give the more liberal 18 month holding period with the 20% long term rate for patent holders. Since the law changed again for tax years after 1997 (back to a unified one year holding period and 20% rate), the one year provision in IRC (1235 changed for only a limited time before the IRS re-affirmed its holding that IRC (1235 always operates to give the most favorable capital gains rate available. Thus, for patents, an invention made on one day can be sold the very next day and still receive what we often refer to as "instant" capital gains treatment.
6. Over the years leading up to 2013, Long Term Capital gains were split into a very low income bracket in which the capital gains rate were 0% for individuals within the 10% & 15% tax brackets, and in which the capital gains rate were 15% for everyone else. To give an idea of the income needed to be in 0% capital gains category, the top of this bracket for 2013 is

\$36,250(single); \$72,500(married) \$48,600(head of household). Given that the marriage rate in the U.S. in June 2013 stands at 31.1%, that heads of household are 8% of the adult population, single persons make up 63.3% of the population and marrieds make up the other 28.6%, the median taxpayer income assumes a weighted average of \$47,530 making the Bayesian assumption that the same percentage of the population occurs across all the brackets. Zero rate capital gains for patent licensing income may occur rarely for two reasons. First, \$47,530 is below the national median income, even though the national median income has been falling. (National median household income was \$55,538 in 2007 has declined to \$51,404 in February 2013). Second, and as will be shown, the capital gains bracket is driven by the sum of ordinary income and capital gains income, meaning that to attract a 0% federal long term capital gains rate, a selling inventor must make less than the 25% bracket for all income (both ordinary and long terms capital gain). Thus the single inventor must have a combined income level of no more than \$36,250, including wage earnings, long term capital gain, interest on bank accounts, etc. The 36,251st long term capital gains dollar will attract a long term capital gains rate greater than 0% and have an associated tax of more than \$0.

7. Ordering Rules: Internal Revenue Code (26 U.S.C.) §1(h) “Maximum capital gains rate” sets forth a complex “excessing” scheme which sets up ordinary income in (A), and creates categories of capital gain “excess” amounts in (B) 0%, (C) 15%, and (D) 20%. To work through this, it is necessary to be able to some definitions, such as “§1(h)(3) Adjusted net capital gain; For purposes of this subsection, the term “adjusted net capital gain” means the sum of—  
 (A) net capital gain (determined without regard to paragraph (11)) reduced (but not below zero) by the sum of—  
     (i) unrecaptured section 1250 gain, and  
     (ii) 28-percent rate gain, plus  
 (B) qualified dividend income (as defined in paragraph (11)).”  
 Once these anomalous items are removed from the long term capital gains category, the “adjusted net capital gain” amounts can applied to the ordering rules of §1(h).

8. The “Obamacare” provision appears at Internal Revenue Code (26 U.S.C.) §1411. Obamacare, as to royalties, is a 3.8% tax which is applied to the lesser of an AGI adjusted amount as MAGI which is AGI increased by any deductions for §911(a) for U.S. citizens living abroad (\$97,600 for 2013). §1411 for individuals:  
 (a) In general  
 Except as provided in subsection (e)—  
 (1) Application to individuals  
 In the case of an individual, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax equal to 3.8 percent of the lesser of—  
 (A) net investment income for such taxable year, or  
 (B) the excess (if any) of—  
     (i) the modified adjusted gross income for such taxable year, over  
     (ii) the threshold amount.

The only case I can imagine for the net investment income at this time, is someone who has large tax-free bond income in which case the 3.8% tax might apply to the lesser MAGI. It should be commented that at a time when the other parts of the world continue on with their situs-based tax systems which encourages its countries’ citizens to go abroad and to act both as cultural ambassadors and to potentially make larger sums of income, the U.S. tax laws only offer a modest deduction (\$97,600 for 2013), and only after foreign residency is established. And even this very modest deduction (other countries generally never tax their foreign residents) is made to suffer being re-included in the AGI (via MAGI) to be taxed by the Obamacare tax provision.



The new tax law also includes a 0.9% hike for FICA Medicare taxes which is applied for amounts earned in excess of the same thresholds which are operative for the Obamacare 3.8% tax. The 0.9% tax is paid by the worker whether self-employed or as a regular employee. Thus it is a departure from the tradition of sharing the burden with employers. The 0.9% Medicare tax will join its fellow Medicare taxes previously pegged at 2.9% unlimited, to form a 3.8% unlimited tax above the threshold. Withholding employers, even though not obligated to chip-in, are obligated to withhold the 0.9% tax.

9. Two EXTREME Examples to illustrate the unpredictability of the new rate structures

WARNING: both of these examples are simplified and leave out many factors that would be considered in real-life circumstances.

**Example 1**

(prolific inventor): Inventor is a married, self employed sole proprietor performing a service and earns \$100,000. Inventor perfects invention and performs a license/sale is paid \$600,000 in royalty sale proceeds in 2013. Exclude personal exemptions and self employment tax, for simplicity.

Ordinary rates are applied first and using standard tax tables the jointly filing inventor pays \$16,852 tax on the ordinary income.

Sale royalty is all long term capital gain under §1223 without a holding period.

The inventor has exceeded 0% rate bracket (pegged at \$72,500 for married filing jointly) with his first \$100,000 in earnings and clearly begins his first capital gain dollar within the 25% bracket which is taxed at 15%. The 20% capital gains bracket is associated with the 39.6% bracket, and for married taxpayers begins for amounts in excess of \$450,000. The amount of royalty which is taxed at 15% is \$350,000 (because the 15% capital gains rate is associated with the ordinary tax rate bracket which is applicable up to \$450,000 for married couples) thus the \$350,000 gap exists between the \$100,000 of ordinary income already used up in the 35% bracket and until the 39.6% bracket is reached at \$450,000 ( $\$450,000 - \$100,000 = \$350,000$ .) Applying the 15% rate to this \$350,000 amount gives \$52,500.

The amount of the remaining capital gain which is associated with the 39.6% ordinary bracket is \$250,000 ( $\$600,000 - \$350,000 = \$250,000$ ). Applying the 20% rate to this amount gives \$50,000 in tax.

Next, the Obamacare 3.8% tax is applied for capital gain income in excess of the threshold for married joint filers, or \$250,000. In the Example, the \$250,000 limit is met with the first \$100,000 of ordinary income added to the first \$150,000 of capital gains. This amount is Obamacare 3.8% tax free. Of the capital gain amounts beyond this first \$150,000 of capital gains is \$600,000 - \$150,000 of capital gains already counted, or \$450,000. Thus the remaining \$450,000 of capital gains is subject to the 3.8% tax and applying the rate gives \$17,100.

California's total tax, using the chart below, summing the rates from each of the underlying brackets cumulates to \$62,488 ( $(\$14,910 - \$0) * .01 + ((\$35,352 - \$14,911) * .02) + ((\$77,452 - \$55,795) * .06) + ((\$97,884 - \$77,453) * .08) + ((\$500,000 - \$97,885) * 0.093) + ((\$600,000 - \$500,001) * .103) + ((\$700,000 - \$600,001) * .113)$ )

Total federal tax is ( $\$16,852 + \$52,500 + \$50,000 + \$17,100$ ) or \$136,452. Combined Fed & State: \$198,940

Total combined federal and state tax rate is  $\$198,940/\$700,000 = 28\%$   
California is  $\$62,488 / \$136,452$  or 46% of the federal tax burden.

Observations:

(1) Prior to the California and Federal increases (example: 2011) the Total federal tax would have been  $(\$17,060 + \$90,000)$  or  $\$107,060$ . California would have been  $\$60,305$ . Total Combined Fed & State:  $\$167,365$

Tax increase over the last two months of 2012 for this set of facts was  $\$199,757/\$167,365 = 1.19$   
 $= 19\%$  increase.

(2) The federal increase is  $136,452/\$107,060 = 1.27 = 27\%$ ; state increase is  $\$62,488/\$60,305 = 1.036 = 3.6\%$

(3) If the inventor had moved to a non-income tax state (Texas, Nevada, Florida) before the sale, about  $\$60,000$  per year in California tax from both wages gains would have been saved, and over the 20-year life of the patent, both combined would cumulates to  $\$1.2$  million.

(4) This example may be illustrative, for example, of an inventor who spends all of their time inventing, and possibly with a spouse who has regular employment, a.k.a. the “prolific inventor”

(5) Self-employment tax in this case would have been an additional  $\$15,300$ .

## **Example 2**

(hobby inventor): Inventor is a married, self employed sole proprietor performing a service and earns  $\$600,000$ . Inventor perfects invention and performs a license/sale is paid  $\$100,000$  in royalty sale proceeds in 2013. Exclude personal exemptions and self employment tax, for simplicity.

Ordinary rates are applied first and using standard tax tables the jointly filing inventor pays  $\$185,246$ .

Sale royalty is all long term capital gain under §1235 without a holding period.

The inventor has exceeded the 0% & 15% rate brackets with his first  $\$600,000$  in ordinary income earnings and clearly begins his first capital gain dollar within the 39.6% bracket (since the ordinary 39.6% bracket starts after  $\$450,000$  of total income) and which is taxed at 20%. The 20% capital gains bracket is associated with the 39.6% bracket, and for married taxpayers begins for amounts in excess of  $\$450,000$ . The amount of royalty which is taxed at 20% is  $\$100,000$ . Applying the 20% rate gives  $\$20,000$  tax.

Next, the Obamacare 3.8% tax is applied for capital gain income in excess of the threshold for married joint filers, or  $\$250,000$ . This is just  $\$100,000$  capital gain income and applying the 3.8% tax rate gives  $\$3,800$ .

California’s tax, using the chart below, for  $\$700,000$  income, as before, cumulates to  $\$62,488$   
Total federal tax is  $(\$185,246 + \$20,000 + \$3,800)$  or  $\$209,046$ . Combined Fed & State:  $\$271,894$

Total combined federal and state tax rate is  $\$271,894/\$700,000 = 38.8\%$

California is  $\$62,488 / \$209,046$  or 30% of the federal tax burden.

10. Provisions, charts and limits for 2013 for the above Example 1 and Example 2

Tax Bracket	Capital Gain Tax Rate	
	Short Term	Long Term
10%	10%	0%
15%	15%	0%
25%	25%	15%
28%	28%	15%
33%	33%	15%
35%	35%	15%
39.6%	39.6%	20%

Federal Threshold Table  
Operates (a) Obamacare 3.8% Tax, (b) Medicare 0.9% FICA tax

Filing Status	Threshold Amount
Married filing jointly, or Qualifying Widow[er]	\$250,000
Single, Head of Household	\$200,000
Married filing separately	\$125,000

Rate	Single Filers	Married Joint Filers	Head of Household Filers
10%	\$0 to \$8,925	\$0 to \$17,850	\$0 to \$12,750
15%	\$8,925 to \$36,250	\$17,850 to \$72,500	\$12,750 to \$48,600
25%	\$36,250 to \$87,850	\$72,500 to \$146,400	\$48,600 to \$125,450
28%	\$87,850 to \$183,250	\$146,400 to \$223,050	\$125,450 to \$203,150
33%	\$183,250 to \$398,350	\$223,050 to \$398,350	\$203,150 to \$398,350
35%	\$398,350 to \$400,000	\$398,350 to \$450,000	\$398,350 to \$425,000
39.6%	\$400,000 and up	\$450,000 and up	\$425,000 and up

2013 California Ordinary Income Table

(Filing Single)/(Filing Joint)	Old Rate	Prop 30 Rate	Total Rate
(\$0-\$7,455)/(\$0-\$14,910)	1.0%	0.0%	1.0%
(\$7,455-\$17,676)/(\$14,911-\$35,352)	2.0%	0.0%	2.0%
(\$17,677-\$27,897)/(\$35,353-\$55,794)	4.0%	0.0%	4.0%
(\$27,898-\$38,726)/(\$55,795-\$77,452)	6.0%	0.0%	6.0%
(\$38,727-\$48,942)/(\$77,453-\$97,884)	8.0%	0.0%	8.0%
(\$48,943-\$250,000)/(\$97,885-\$500,000)	9.3%	9.3%	9.3%
(\$250,001-\$300,000)/(\$500,001-\$600,000)	9.3%	1.0%	10.3%
(\$300,001-\$500,000)/(\$600,001-\$700,000)	9.3%	2.0%	11.3%
(\$500,001-\$1000,001)/(\$700,001-\$2000,001)	10.3%	2.0%	12.3%
(1000,001+)/(2,000,001+)	10.3%	3.0%	13.3%

11. Observations On the Extreme Examples:

- (1) Prior to the California and Federal increases (example: 2011) the Total federal tax would

have been  $(\$179,139 + \$20,000)$  or  $\$199,139$ . California would have been  $\$60,305$ . Total Combined Fed & State:  $\$259,444$

Tax increase over the last two months of 2012 for this set of facts was  $\$271,894/\$259,444 = 1.0479 = 4.8\%$  increase.

(2) The federal increase is  $209,046/\$199,139 = 1.049 = 4.9\%$ ; state increase is  $\$62,488/\$60,305 = 1.036 = 3.6\%$ . Therefore the increases are about the same, and the blended increases are consequently the same.

(3) As before, If the inventor had moved to a non-income tax state (Texas, Nevada, Florida) before the sale, about  $\$60,000$  per year in California tax from both wages gains would have been saved, and over the 20-year life of the patent, both combined would cumulates to  $\$1.2$  million

(4) This example may be illustrative, for example, of a hobby inventor who spends weekends inventing, and possibly with a spouse who has no significant employment, for example.

(5) Self-employment tax in this case would have been an additional  $\$39,675$ .

#### Comparison Observations

- (1) The fact that both the federal and state increases are more nearly the same for people who are predominantly employed rather than passively receiving income is marked.
- (2) Given the fact that the new tax increases hurt inventors who are licensing their patents, and given the traditional preference given to inventors under the federal tax code, (instant capital gains is about as favorable as you can get) and possibly ignoring any anti-invention bias of the Obama administration, it would seem to range between inadvertent and unfortunate inventive inventors are punished along with other, non-inventive money investors. Now may be a good time for invention royalties to be excluded from the reach of the 3.8% Obamacare tax.
- (3) The incentive for inventors to move out of a high tax state have only increased "a little". There are other disincentives to move from a high tax state, particularly to save production costs. For a married couple at the level of  $\$1,000,000$  in sale royalties, the California tax blended tax rate is 10%. This is a strong incentive for an up-and-coming prolific inventor.
- (4) The main take-away in each of the examples as compared to the state of affairs before these tax increases, especially the federal tax increase, is the complexity that was necessary in computing the federal taxes as based upon the AGI (or MAGI) of the taxpayer. As can be seen, the "prolific inventor" is hit hard by the tax increases. Unfortunately, this may lead to tax reduction planning that may not eventually work. This may be a return to the 80's where the (dangerous to the inventor) use of merger and acquisition techniques are used to try to give the inventor tax delayed value.

12. Despite the above tax increases the key to capital gains treatment is to be a "holder" as defined in the Internal Revenue Code. A holder can be the inventor or one who bought from the inventor, but not those who are merely in privity with the inventor. A holder is further defined as one who obtains an interest in the technology before it is actually reduced to practice. Investment partners and investment co-owners who contribute capital can qualify as holders, so long as the contribution is made before actual reduction to practice. (Note that constructive reduction to

practice, meaning that the inventor has filed a patent application, does not apply here. See Reg §1.1235-2(d)(3)). Further, a holder must actually own a portion of the invention rather than a contractual right to future income (which would constitute some form of loan or option). According to Reg. §1.1234, an actual reduction to practice is defined as follows:

13. For the purposes of determining whether an individual is a holder under paragraph (d) of this section, the term “actual reduction to practice” has the same meaning as it does under section 102(g) of title 35 of the United States Code. Generally , an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs. This presents a real problem for inventors to move the invention to the “proof of workability” stage before seeking capital to further exploit the invention to an acceptable level of efficiency required for commercial viability.
14. Thus, “reduction to practice” means totally different things in the patent law versus the tax law. In patents, reduction to practice means either the building of the device to the level of invention to be claimed in a patent, OR the filing of an enabling patent application. In the tax law it means the actual building of a device which demonstrates the MINIMUM level of operability. In a patent, this would correspond to the broadest claim. In a patent clearly drawn to an improvement over a prior art device, it would be a showing of a non-obvious level of improvement over that minimum level of prior art. Thus, where such an invention is the case, a careful documenting and identification of that breakthrough would be required to prove up “reduction to practice” AFTER an investor invests in the invention.
15. Important points to remember and problems to avoid:
  - (a) If possible, bring investors on board before the patent is reduced to practice so that they can be “holders.”
  - (b) Inventors and other holders do not have to wait the traditional year in order to get long term capital gains on the sale of the technology , but instead have instant long term capital gain status.
  - (c) The term “a patent” refers to a patent in its entirety. Unlike copyrights, subdivisional portions of a patent (which, of course, covers a single country) cannot be “sold” (rather than licensed) and still have the transaction qualify for capital gains treatment. It is our understanding that this point has never been litigated.
  - (d) A transaction with a “related party” will destroy the capital gains treatment under IRC §1235. (or even outside §1235)
  - (e) Where an employee is paid an amount of royalty, even over the full term of the patent, this will generally constitute compensation for services as ordinary income, and capital gains are not likely to be available. However, some cases have indicated that capital gains may be available where (a) the employee was not hired to invent, (b) the services are ancillary to the patent transfer, and (c ) the taxpayer has an arrangement before beginning employment.
  - (f) Since actual reduction to practice under the regulations may occur later than the application for patent, an opportunity exists for bringing in investor-holders after the application for patent is submitted.

- (g) The right to deduct research and development expenditures as set forth in above is even more critical to new technology ventures because the tax advantage of these deductions are not recaptured if the technology is later sold. To illustrate an extreme example, assume that \$1,000,000 of personal monies is spent on research in year 1 and is deducted as an expense under §174. (Ignore ademption of personal deductions and other “hidden tax” for the high income rate payer.) The value of this tax deduction at a 39.6% top marginal rate is \$396,000. Although the invention would usually be sold for much more, if the invention is sold for \$1,000,000 under IRC §1235 on the day after the patent filing date and is taxed at a current federal capital gains rate of 0-23.8%, the tax burden would be (assuming all passive and no FICA whatsoever) close to:  
 Single: 0% of \$36250 + 15% of (\$400,000 - \$36,250) + 20% of (\$1,000,000 - \$400,000) + 3.8% (\$1,000,000 - \$200,000 Obamacare threshold) = (0 + 54,562 + 120,000 + 30,400) = \$204,962  
 Married: 0% of \$72,500 + 15% of (\$400,000 - \$72,500) + 20% of (\$1,000,000 - \$450,000) + 3.8% (\$1,000,000 - \$250,000 Obamacare threshold) = (0 + 49,125 + 100,000 + 28,500) = \$187,625
- (h) IRC §174 disrupts the direct connection between general research and a patent project that there is no recapture (Rev. Rul. 73-395, 1973-2 CB 87). For financial illustration purposes only, and referencing the recapture case (using IRC §1245 property) purely for contrast, assume that an item costs \$1,000,000 and has been held more than one year so that the 0-23.8% capital gains rate applies. Lets assume that straight line depreciation would result in an \$800,000 adjusted bases, but that accelerated depreciation was taken so that the item has an accounting book value (or basis) of \$600,000. If the capital item were to sell for \$2,000,000, the sales price would be treated as follows: \$600,000 would represent a non-tax return of capital; \$200,000 of the gain over basis would be “recaptured” depreciation and would be taxed at ordinary rates (since it was previously depreciated with a savings based upon ordinary rates); and, amount taken at straight line depreciation would be capital gain, and the \$1,000,000 gain over the purchase price would also be taxed at capital gains rates. If recapture rules had applied, the \$200,000 depreciation would be lost by taking amounts back into ordinary income. Without recapture, the full \$1,400,000 would be tax at long term capital gains rates.
- (i) Most inventors confuse patent ownership with manufacturing liability. A patent is a negative right, i.e., the right to prevent others from making, using and selling the invention. A license is essentially acceptance of money as consideration for not suing the licensee. There is virtually no liability to a patent owner for merely owning a patent. (However, abusing or misusing a patent can result in liability, for example, where the owner attempts to enforce a patent he knows to be invalid.) A manufacturer can hold a patent passively while manufacturing the patented article, but is not necessarily subject to liability merely by doing so. Consequently, there is really no advantage to be gained by putting a patent into a corporation in an IRC (351 transaction; doing so would essentially eliminate an inventor’s tax advantages for subsequent sale both under IRC § 1235 “instant capital gains” and outside IRC §1235 (one year holding period requirement), because corporations are taxed on capital gain property at the same rate as ordinary profits.
- (j) The manufacturing side of the business should have some liability shields, such as a corporate or LLC form, adequate commercial liability insurance, and preferably a patent rider in the event that the manufactured product infringes someone else’s patent. If a corporation is an exclusive licensee, it can make its own decisions about who should be sued for infringement of its patent, as well as when and where suit should be brought.

- (k) Patent rights may also be divided with a license agreement according to geography, type of product, time duration, and the like. An agreement for the sale of a patent, rather than a license, must involve the sale of substantially all of the rights in the patent. The regulations provide that a license is not a sale where: (a) the transfer is geographically limited to less than all of the geographical area of the country of issuance; (b) the transfer is limited to a time period less than the length of the patent protection period; (c) the licensor limits the licensee to specific industries or trades; (d) the licensor attempts to license some claims and exclude others; (e) the licensor prohibits further sublicensing; (f) the right to use or sell are retained by the licensor; (g) the right to terminate the license is unilaterally retained and exercisable by the transferor; and, (h) the licensor has the right to terminate on a condition subsequent beyond the control of the licensor. Conversely, note that foreign rights can be sold and retained individually, by country, with each country's rights constituting a separate asset.
- (l) Retained rights which do not prevent a holding that substantially all rights were transferred in the license (i.e., retention of rights such that a true sale of the patent is not undermined) include (a) retention of an option to sue on the patent, (b) an agreement in the license to jointly pursue litigation with the licensee, (c) a provision where either the licensor or the licensee could bring suit for infringement, (d) retention by the licensor of a security interest, and (e) retention by the transferor of the right to use the invention.
- (m) Only where substantially all of the rights are transferred can capital gains treatment be afforded. Otherwise, the money received from the purported sale will be treated as ordinary income. In other instances the taxpayer may have divided the patent rights in a series of non-exclusive licenses. Where the taxpayer is highly involved in administering the licenses and is involved sufficiently to consider it as a business, self-employment tax must be paid.
- (n) Inventorship is a somewhat non-exciting body of concern, but can be just as damaging as a "no invention" tax maneuver. For a regular patent, and especially where there are more than one inventor, anyone who came into contact with the project should record their contribution. This will be needed in any event should the Examiner restrict the inventions and their associated claims.
- (o) Tax law littered with dead bodies of "pretend inventors" with "pretend licenses". If the invention is not real & the transaction not reasonable, the IRS might re-write your deal to their liking, send a tax bill and possibly arrange for some R&R at "Club Fed".
- (p) Avoid putting a patent in any corporation or LLC unless you are ABSOLUTELY CERTAIN you will not seek to sell it within a year. Even if the sale will occur beyond a year, the buyer may not want to buy your whole corporate organization.
- (q) I'm not convinced that Provisionals are fully recognized outside the country filed, (see Paris Convention Treaty 4a(2), 4c(4) & 4bis 5. Any invention disclosure, public use, sale, or Internet exposure which occurs before an effective date of a real patent filing can arguably cause a loss of rights outside the country where the provisional is filed. Any domestic multiple filing which done at a higher frequency can help to capture more and more content, & earlier within that country. However, there is no serial filing for provisionals which cannot also be done as a serial continuation-in-part filing. Serial continuation-in-part filing protect each filing internationally, & without having to worry about both a U.S. follow-on filing and foreign filing concerns at the 1-year anniversary.
- (r) I know of only one main set of facts where a provisional has any advantage: A French

inventor who files a regular case in France can apply for U.S. FDA permission the next day and wait out his treaty year while the FDA is considering his application. Without a provisional, the U.S. inventor cannot mimic the French inventor's action, namely file for a provisional, keep the invention a secret and then file a follow-on application the next year. The effect of both of these examples is to delay a future income stream by one year, normally an undesirable effect. The ONLY plausible reason for pursuing a provisional application, over a regular application, is the deliberate postponement of the 20-year time frame of the regular U.S. patent application. Further, the only reason known to justify the deliberate postponement of the 20-year time frame of the regular U.S. patent application under circumstances where the invention may not be used, sold or practiced in public under law. The only example of this type of temporary prohibition on use that I know of is an invention requiring FDA approval.

16. LEAVING CALIFORNIA: In the preceding examples which illustrates the advantage and the differential tax rates available from a federal tax perspective, it should be kept in mind that the state of California does not offer any break for capital gains income. As a result, selling a zero basis patent for \$1,000,000 would cause the taxpayer to pay about 10% of that amount to the state. It might be a good idea to be a bona fide resident of Nevada or Texas at the time of sale, particularly if the net present value of the income stream tops one or two million dollars. The tax savings could potentially support the purchase of a modest house in Nevada.

17. DONATING A PATENT

- (a) The tax code is littered with cases from financial maneuvers that revolve around non-existent inventions, as to matters NOT involving nonprofits. However, in the past few years, individuals and companies have attempted to donate worthless patents at overstated values to take advantage of a charitable mechanism enabling a write-off for fair market value of appreciated assets. The usual rule is that the donee takes the donor's basis and that a charitable donor can write off only the amount of cash basis that the donor had in the property.
- (b) For charitable donations, the donor has previously been able to write off the fair market value of the item (perhaps the theory was that a donor should not be forced to sell the item even at a 0-23.8% capital gains rate and then donate the leftover cash to the charity, especially where such a sale followed by cash donation might result in a limitation on the deduction where the amount exceeds the 50%, 30% or 20% deduction limits). The limit is still there, but will operate to reduce deductibility without inclusion into income. This rule improves the efficiency of charitable transfers, and is especially helpful for charities because it enables them to get the items they want.
- (c) The area of charitable donations as related to patents seems so lucrative that promoters have entered the field to attract investors who promise to pass the tax benefit of charitable donation back to the investor. Charitable donation of patents is also suspect because most patents have a zero basis because of the ability to deduct under IRC §174. The IRS has issued warnings that it will challenge such attempted write-offs based upon the following paragraph from Notice 2004-7:
- (i) Transfer of a nondeductible partial interest in intellectual property; 2) the taxpayer's expectation or receipt of a benefit in exchange for the transfer; 3) inadequate substantiation of the contribution; and 4) overvaluation of the intellectual property transferred. The purpose of this notice is to advise taxpayers that, in appropriate cases, the IRS intends to disallow all or part



of these improper deductions and may impose penalties under §6662. In addition, this notice advises promoters and appraisers that the IRS intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers of the intellectual property may be subject to penalties under §§ 6700, 6701, and 6694.

- (ii) As of the effective date of HR 4520, IRC §170(e)(1) was amended to include, along with prohibitions on write-offs in excess of the lesser of basis or FMV for unrelated property and for donations to private foundations, the prohibition on donations of intellectual property. The added section reads:
- (iii) of any patent, copyright (other than a copyright described in §1221(a)(3) or §1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in §197(e)(3)(A)(I)), or similar property, or applications or registrations of such property.
- (iv) However, new sections (IRC §§170(m) and (n)) were added which enable donors to take an additional write-off for donated intellectual property based upon the income it generates for the charity, calculated according to a declining rate schedule. This gives the donor a generally linearly declining amount of write-off for income received from the charity over a 12 year period, ranging from 100% in the first two years and reduced by ten percent per year to a level of 10% in the last two years. The intent of both IRC §170(e)(1) and IRC §§170(m)&(n) taken together is to encourage donation only of items having real value and to limit the write-off based upon real income potential. It is also a realization, as discussed elsewhere in this paper, that the value of intellectual property focused at a moment in time may be speculative, a better idea being to reward donors based upon the actual amounts of money received by the charity. However, given a patent's 20 year life and a discounted system, even neglecting the losses in value from the donor being forced to sell the patent at a 0-23.8% rate to get a tax write-off on the remaining amount may be preferable, even if the income generated exactly matched the value of the patent, to a 20 year weighted average write-off of 33%.
- (v) The stated limitation is based upon the lower of fair market value or the taxpayer's basis. As mentioned, unless there is a possibility of loss of NOL's (less likely with the new 5 year look back period -- with appropriate limitations of the ability to offset no more than 50% of the taxpayers income in the 5th year) the vast majority of taxpayers will elect to expense all research expenditures under §197 as soon as they occur. As a result, for patents they will have a zero basis and will not yield any deduction upon donation. To the extent that some value exists within a patent based upon a basis greater than zero, the value is supposed to be apportioned over the life of the patent.
- (vi) IRC § 170(e) states that the charitable contribution of property shall be reduced by the sum of non-long term capital gain which would have resulted upon sale (generally), and combined with the amount that would be long term capital gain which would have been realized had the property been sold by the donor, for: (a) tangible personal property which is unrelated or which is related and subject to recapture, (b) private

foundation donee property, (c) patents & copyrights, trade secrets, trade names, know how or similar property, or (d) taxidermy property.

- (vii) Where patents and other intellectual property has been donated and where such property generates income for the charity, IRC §170(m) allows the donor to count such donee income received due to the patent or intellectual property as an “additional” deduction. This provision is limited to a 10-year period after the date of donation (IRC §170(m)(5)), and also limited to the life of the property (IRC §170(m)(6)). This provision is consistent with other provisions which (1) enable a donor limited to the basis of the property to receive deductions based upon actual cash flow from the donated property, and (2) limit a donor’s deduction where the charity sells “unrelated purpose” property donated for less than the property was valued at the time of donation. Both of these types of provisions extend the “lifeline” between the charity and the donor and keep them somewhat tied together regarding donated property.

## 18. AVOID THE §351 IMPERMISSIBLE TYPE “A” REORGANIZATION TRAP!

- (a) Despite warnings by us to avoid putting a patent into a foreign entity, we continue to encounter inventors who are enticed into (tax suicide) along the following lines. A young start up company (YST) sees that an inventor’s patent is valuable, but cries (poor) at any mention that the inventor should receive any money at all for his invention. The YST offers extremely restricted stock in exchange for the patent, but the inventor knows that the value of such restricted stock is/may be significant and that the IRS would value it and then send the inventor a bill for ‘selling( his patent. Even a great 0-23.8% tax rate can be steep if the inventor has no other funds to cover the tax bill. The inventor urges that the invention is so valuable that the YST should dissolve and reorganize around the inventor in a §351 transaction in which the inventor will receive stock of the new company (say 25% for example) and will depend upon stock growth to compensate him.
- (b) The YST president remembers that he has already used up most of the investment money of the current investors and knows that any suggestion to start again from scratch would result in his being shot, hung, and shot again. The president of YST says “Inventor, if your patent was in a corporation, we could merge; you would end up with 25% of the YST stock, and mergers are tax free!” This gives the inventor the idea to start up a small company, Patco, in a §351 transaction, most likely with the patent forming the totality of the investment assets. The inventor then presents his suggestion that Patco merge with YST, in which merger Patco stock is transferred to YST in exchange for YST stock. Patco is discarded, inventor has 25% of the YST stock, and Inventor is sure he is well on his way to riches. The problem is that this is a classically impermissible type “A” reorganization. The result is that the whole transaction is treated as a simple sale of the patent. The inventor gets a bill from the IRS (and his state taxing authorities where applicable) for tax based upon the value of the restricted stock received. Further, the IRS is likely to be very liberal in ascribing value to the restricted stock using the IRS re-characterization rules. The president of YST is not concerned because he acquired the patent in exchange for 25% of his company’s stock, which is what he wanted. The inventor, on the other hand, is in a bind. YST is not about to try to help undo the transaction, has no money to give the inventor (and even if it had the money it likely would not give it to the inventor), and the inventor begins to rack up penalties and interest on the liberally determined share value. Evidence gathered at YST does not help the inventor either. Since YST is probably still attracting investors, the value of the patent

set forth by YST will be, within the bounds of securities law, at least as bright as the bill of goods that YST sold the inventor. Inventor probably has no recourse against YST since YST did not participate in the §351 transaction, YST did not ask many questions about the origins of Patco, and since it is the same to YST as an acquisition of an asset for stock, YST does not care, and would repeat the transaction many time if it were able to do so. It is a sad tale of woe, indeed, and is intended to be a caution against falling for a similar scheme. Despite the fact that capital gains rates are less than 0-23.8% (0% for paupers, pauper status must be proven to the IRS, and going negative (i.e., owing the IRS money you do not have) is the same for every one regardless of financial status.

- (c) There are two doctrines at work here. The first doctrine is the transaction doctrine, which empowers the IRS to look at the totality of the transaction and reduce it to its most direct terms, especially if the intermediate steps add nothing to the transaction especially nothing more than an attempt at tax avoidance. When a patent or application is hastily shoved into a newly formed corporation not having a business, the corporation is then merged to call the patent into ownership, and the newly formed corporation is discarded, it is clear that the IRS will discard the interim transaction and allege a straight sale. The second doctrine at work here is continuity of interest. All of the revenue rulings listed below, namely Rev. Rul. 67-274, Rev. Rul. 70-225, and Rev. Rul. 81-25, emphasize that the continuity of business does not apply to the acquiring corporation, but to the transferring corporation (also known as the transferor of the assets). Therefore, it is the transferor's business which is assessed for continuity under the continuity of interest standard.
- (d) The continuity of interest principle contemplates an ongoing business. In the case of a patent which has been put in the name of a corporation, what is the "business" of such a corporation that is to be continued? Most of the time, the corporation is created for the impermissible type-A reorganization, and it has no business to begin with so will have no business to continue. We are typically NOT speaking of a manufacturing corporation when we talk about a corporation as patent holder, but a mere holder of the patent. With reference to a corporation as a mere patent holder, the only legitimate business of such a corporation might be the business of licensing to third parties. In this case, the acquiring corporation would merely be acquiring the right to a stream of income for an already licensed patent, and the acquiring corporation might well be unable to acquire a monopoly (i.e., 100% of the patent) depending upon existing licenses.
- (e) In the event that a corporation has a patent and an existing business, and provided that the continuity of business standard can be met, the reorganization will not be impermissible because the inventor will have merged an ongoing business (as opposed to a corporate shell which would be empty but for the patent). However, if a corporation is already in business and has an income stream, why would it be allowed to merge with a corporation which has restricted stock and no income to the inventor? This introduces the possibility of cutting off the inventor's salary, so how might one structure the transaction to exploit the tax law in an effort to preserve the inventor's or the patent holder's tax advantages?
- (f) A major indicator of how to structure businesses both (1) to insure that the deductibility of research and development is maintained, and (2) to protect the rights of the inventors and holders may be found in the cases *Green v. Commissioner*, 83 T.C. 667 (1984), and *Scoggins v. Commissioner* 95-1 USTC 50,061; 46 F.3d 950 (9th Cir.). Although other strategies may work, these cases introduce a base strategy which assumes that little or no liability will be incurred from simply owning a patent.
- (g) Because of the major tax increase beginning in 2013, I expect that many more "entity"

tactics will be employed to avoid gain recognition.

19. PROHIBITION ON “NON-TECHNICALLY ACTIVE” INVESTMENT VEHICLES/PARTNERSHIPS

- (a) In the Green case, the deductibility of research and development expenditures was denied where the invention was placed in a limited partnership which functioned only as a “vehicle for injecting risk capital into the development and commercialization of inventions.” Thus, an entity which seeks to claim a deduction should be one which is set up so that it has a chance to enter the regular business relating to the technology development (as opposed to one whose only function is to inject investment and collect profits).
- (b) The “active business” rule really translates into an “active technology” rule. As the Scoggins case demonstrates, the partnership vehicle was ready, willing and able to move on with the technology had the option holder not brought commercialization to the mark. The Scoggins case emphasized that after the technology is sold, being “ready to move on with the technology” is impossible because one no longer has the technology required for moving on; however, several other cases have more subtlety outlined what is impermissible.
- (c) LDL Research & Development II, Ltd, 124 F.3d 1338 (10th Cir. 1997) involved a limited partnership, LDL Research & Development II, which paid development money to a developer, Larson-Davis Laboratories, to develop, manufacture and market acoustic and vibration test equipment. Although it appears from the name of the partnership that the inventors were involved, the facts of the case have shown that the partnership contained no technical expertise and was in no position to do anything with the technology should it have been placed in the care of the partnership. There was a group of inconsistent agreements, some of which would have given exclusive ownership to the partnership, and others of which would have given the developer a non-exclusive license in exchange for a 15% royalty and 5% of the developer stock to the partnership. The developer never exercised its non-exclusive license option, and the partnership never made a move to exploit the technology. In continuing to raise money, the main selling point for the partnership was the ability of the investors to deduct money under IRC §174. It is clear that the partnership could properly have paid others to carry out the research (Treas. Reg. (1.174-2(a)(2))), but the taxpayer must be actively involved in the trade or business, or must at least have a “realistic prospect” of such involvement. The devastating facts were as follows: (1) the partnership had no real prospect of doing anything with the technology; (2) the developer was relied upon to conduct all activities related to the technology; (3) there was only a “mere possibility” that the partnership would ever act. The final holding categorized the partnership as a “passive investor” that was not entitled to the IRC §174 deduction.
- (d) In the 9th circuit case of Kantor v. Commissioner 998 F.2d 1514 (CA 9th 1993), a partnership had an arrangement with a developer such that the developer could, under a Technology Transfer Agreement, for a nominal sum and a royalty obligation, obtain the exclusive right to market the technology. This fact alone indicates that the partnership was taking itself out of the business of dealing with the technology. To make matters worse, when the developer needed more cash, one of the partners acting on behalf of the partnership (1) negotiated to arrange financing for the developer, (2) arranged cancellation of the Technology Transfer Agreement, and (3) had himself appointed to the board of the developer. Later, the partnership signed other agreements with other

companies to market in Europe and America.

- (e) Thus, in this case, the partnership (1) was actively involved in overseeing the research, (2) got rid of the agreement to sell the technology to the developer for a nominal sum, and (3) had other firms sell on behalf of the partnership. These facts would seem to weigh in favor of the partnership had they not occurred as a reversal of initial direction. Had the contract been honored as initially drafted, it is clear that there would have been a sale. The holding against the taxpayer's deduction included these factors: (1) A "realistic prospect" of entering the business concerned with the technology must be manifested early in time, i.e., at the time the taxpayer incurs the research expenditures; (2) a realistic prospect for entering the business concerned with the technology must be coupled with the capability for doing so; (3) the business into which the taxpayer shows ability and intent to enter must be its own business and not the business of another. Here, there was no realistic prospect of the partnership's subsequently entering its own business concerning the technology. The option to grant exclusive rights for a nominal sum, coupled with the lack of objective intent and the lack of actual capability of entering the business provided a clear showing that the partnership was not (in connection with its trade or business.) Put another way, the partnership's trade or business was that of a passive investment vehicle.
- (f) Both the Kantor and LDL Research cases were distinguished from Scoggins and were presented to emphasize the favorable elements of Scoggins, and magnify criticism of Scoggins. The Scoggins case illustrates a generally optimum way to set up a venture both (1) to insure deductibility of research and development, and (2) to leverage the inventor/holder's interests to afford maximum advantage from exploiting both the technology and the business developing the technology.
- (g) Scoggins
  - (i) In Scoggins, the inventors formed a partnership to hold rights in the technology and to pay for the research. At issue in Scoggins was whether the partnership could take a deduction for the research expenditures it paid to a research corporation in which the inventors, incidentally, had a majority shareholder interest. The inventor-partners granted to the inventor corporation (1) a limited, non-exclusive right to exploit the invention, and (2) an option to buy the technology for \$5 million. Cash from the license flowed back to the partnership as did cash from expensing development of the corporation.
  - (ii) This structure has several advantages, as well as a few disadvantages. Since the patent is held in a partnership of the inventors, the inventors continue their holder status, and any sale of the patent to an unrelated entity will result in IRC §1235 capital gains to the individual inventors at the 0-23.8% long term rate. Holding the assets for longer than 12 months results in the 0-23.8% long term rate outside of IRC §1235, including permissible aspects of the transaction such as the 25% aggregate ownership limitation on the seller-related persons in the buyer corporation.
  - (iii) If there is little liability in holding the patent, the flow through of liabilities to the inventors should not be a concern. If the corporation cannot make a success of the technology, the partnership continues to exploit the technology elsewhere and is thus in the business of exploitation of the technology, rather than simply being a vehicle for injecting venture capital. This enables a deduction for expenditures to flow through the partnership and to the partners.

- (iv) In contrast to Kantor and LDL Research, note that the driving force behind the partnership and the developing corporation was the know-how of the inventors. If the developing corporation had not exercised a significant cost option to move ahead, the partnership was ready, willing and able to develop the technology further in different products elsewhere.
- (v) The inventors here also have a majority share of the corporation and control of the business exploitation. If the corporation begins to generate large amounts of cash, the inventors can have the corporation exercise its option from the partnership and purchase the technology outright for \$5M, which will result in taxation to the inventors through the partnership at the 0-23.8% instant long-term capital gains rate if the corporation is unrelated. The criticisms in this case are that (1) the inventors own more than 50% of the corporation for purposes of creating a sale outside of IRC §1235, and (2) the inventors as an aggregate own more than 25% of the corporation for effecting a sale within IRC §1235. As a result, it is clear that the most desirable action would be to secure long term gain through stock. As the corporation grows, it may be successful enough to go public, in which case the inventor's stock will increase but will not be tax-recognized until the sale of the stock, which will again invoke capital gains tax rates (assuming it is held for more than a year).
- (vi) In the case of a partnership, it is the individual partner who can qualify a patent holder rather than the partnership as a whole. A partner who does not independently qualify as a patent holder does not qualify for instant capital gain treatment under §1235. It may be that two inventors can arrange to have their technology held together so as not to be in partnership, although it is uncertain whether such an endeavor would be successful; for example, a common disposition agreement could be drafted to avoid cumulating their interests as partners for either the 50% provision outside IRC §1235 or the 25% provision within IRC §1235. However, a move to isolate the inventors from each other may also be likely to eliminate the "in connection with its trade or business" aspect, as per the Kantor and LDL Research cases, causing loss of the investment.
- (vii) Because an the inventors' ability to move sale money through to themselves at a 0-23.8% tax rate as holders within IRC §1235, or even as owners outside of IRC §1235, it might have been prudent if they (1) had severely limited inventor ownership of the developer corporation, and (2) had given the holder corporation the option to buy the technology from the unrelated inventor's) for a significant outlay. Without a significant outlay, the courts are likely to hold that the inventors are making a simple sale through an investment partnership. Only a significant barrier to "buy off" the inventors will keep the inventors in a position of being "in connection with its trade or business."
- (viii) On the other hand, if the inventors are so committed to corporate growth that they expect to derive all of their income from the accumulated value of stock, the inventors may as well enter the corporation from the outset. An option to buy from a corporate-related taxpayer will either have (1) a sales price magnitude large enough to meet the Kantor and LDL Research cases (thereby producing a huge undesirable ordinary taxable income stream), or (2) a negligible sales price magnitude, such that a partnership will lose its IRC §174 deduction, and there will perhaps be a delay of money to the inventor where a negligible magnitude option is set to trigger at a much later time.

- (ix) It makes no sense to split the inventor/ inventive partnership compensation between future stock growth and the initial sale/option of the technology. Where a developing corporation claims poverty in the early years of development, an initial sale by license with an escalating royalty rate can give the inventors the ability to reap the benefits of a maturing industry while leaving the developer some leeway in the early years for development which is not substantially burdened by inventor payment considerations.
- (x) An immediate question which arises from the foregoing is whether an LLC will be given the same respect as a partnership. Unless one wishes to try to make new law, it may be advisable to stay with the established partnership precedent, particularly since there should be no significant downside from simply holding honestly and truthfully obtained patents. Moreover, a partnership need not be registered with the state and will not be taxed, even at the low rate of an LLC.

## 20. TAX TREATMENT OF THE PURCHASER/LICENSEE

- (a) In general, the purchaser of a capital asset is required to capitalize the purchase price and depreciate a portion of the asset's value each year, such as for a building or a piece of equipment. This is true for lump sum purchases and usually true for periodic payments not based on productivity or use. Where a series of payments are made, the transaction is treated as a sale subject to a loan, and the IRS commissioner will impute a reasonable interest rate into the transaction.
- (b) Where the payments are dependent upon the patent's use or production, it is considered that the payments are closely related enough to the value of the patent that they are deductible in the year paid or accrued. This rule is from *Associated Patentees, Inc.* 4 T.C. 979 (1945), and it has clearly survived for over half a century.
- (c) Purchasers may hold the patent as a capital asset under IRC §1221 (where it is not used in business) or IRC §1231 (but only where gains exceed losses). The holding period is one year for long term tax rates (0-23.8%), but court-modified tax laws have established that actual reduction to practice is necessary before the holding period will begin. Again, reduction to practice means an actual reduction to practice sufficient to demonstrate that the inventor's idea works.

## 21. A POSSIBLE BETTER ARRANGEMENT?

- (a) A better arrangement might be where the transferee corporation has less than 25% of its ownership in common with the inventor partnership, with the best scenario being zero common ownership between the transferee corporation and the inventor partnership. The inventor partnership would optimally grant to the transferee corporation (1) a limited, non-exclusive right to exploit the invention, and (2) an option to buy the technology for big money, possibly on an escalating schedule. Conversely, the transferee corporation would sell its stock to the inventor partnership for a de minimis price (or would simply give the stock to the inventor partnership). The transferee corporation would ideally make an IRC §83(b) election so restricted that it is ineffective for ownership, or would possibly give incentive stock options contingent upon purchase. Low-level cash to cover expenses would flow into the inventor partnership as a result of the license, as would cash resulting from the corporations expensing of development costs.

- (b) The non-exclusive limited license is only necessary where it is required that the developing company have an exclusive or non-exclusive right to exploit. Normally, where no “exploitation testing” is necessary, a simple license/sale with an initial low royalty followed by escalating royalties can achieve the same result as the non-sale followed by sale treatment, at least from an economic standpoint; additionally, this approach affords early tax breaks on the initial royalty dollar.
- (c) In the proposed scheme, the grant option to buy the technology for big money on a potentially escalating schedule will be necessary keep the investment partnership “active.” The use of use of the option will leave the partnership active while putting the buyer to the test in terms of exercising the option. Much of the mix of these options will depend upon product development in terms of funds required, time required, and funds expected.
- (d) Even where corporate profit participation is sought, insure that true ownership only begins when the option and sale finally occurs. Note that before the sale, it is a good idea to set any cash flow approximately equal to any expenditure by the partnership for research under IRC §174. Allocations of this nature should always be used to avoid generating funds which would be taxed at 40-50% while using money for expenses which would be taxed at 0-23.8%. Warning: if an entity or person begins to generate patents, there is a danger that the patents might begin to be treated as a vendor’s inventory. In this event, many of the tax advantages will be lost. In *Kucera v. Commissioner, T.C.M. (RIA) ¶ 51090*, the Tax Court held that an inventor with 21 inventions and several patents was still not a professional so was entitled to capital gain treatment. In *Lockhart v. Commissioner, 258 F.2d 343 (3d Cir. 1958)*, the inventor had 37 patents over a 19-years & was ruled a professional. Much depends upon how you operate and how you hold yourself out to the community.

## 22. WHAT IS IT WORTH?

- (a) Today, so many pro-big-government “taxaholics” relate tax issues to “governmental loss of income,” when in reality the citizen and business that funds government should look to government as a service rather than as a master. The capitalization and subsequent amortization or deduction of funds invested represent interest free loans of an advance of tax revenue to the government. As an illustration, where an investor spends \$1000 on a project and makes the \$1000 back before the end of the year, he has broken even and should report no profit for that year and pay no tax. Real cash flow profits will be made in the future, not during the break-even year. Where the \$1000 must be capitalized and written off at 10% per year, the government is in effect causing the payment of tax on \$900 profit in the first year, and will repay the “advance” taxes paid on the \$900 profit to the taxpayer in nine increments in the future, with no adjustment to the taxpayer for the loss of the time value of the 10 year loan to the government.
- (b) The value to the individual licensor-inventor/holder with a high tax rate is straightforward at the 20% differential between the top ordinary rate of 39.6% and the 0-23.8% long term capital gains rate (patents instantly and other capital assets if held for more than 12 months before sale). This differential may rise and fall slightly where the individual is in the “surtax” or “ademption of allowances” region of income where his standard or schedule A deductions and his personal exemptions are being recaptured.
- (c) Higher tax rates may actually be more than 39.6% due to the ademption of personal deductions and other deductions. However this aspect should only be considered where the taxpayer can shift his or her efforts into patent activities (or indeed other capital gains



sale activities) to thus transfer the otherwise ordinary income into capital gain income. Further, the effect is usually so small so as to be considered negligible.

- (d) To assess value to the licensee, we can begin by assuming that the purchase price for the patent is the same as the stream of income associated with the productivity of the patent. This ignores any additional royalty which should be due from eliminating the risk of new technology on the part of the licensee, because a series of payments based upon actual use of the patent should equate to greater business gains associated with the risk. In other words, where a licensee buys a patent outright and the technology changes, permitting the patented item to be made much better by a different method, the patent will become worthless. This is what is meant by “risk of change in technology.”
- (e) Next, we can compare 20 year straight line amortization versus expensing of the patent based on a license where the licensee pays a flat rate per patented item produced. The full 20 years can be used where the patent application is sold immediately after filing, because IRC §1239(e) enables depreciation of the patent application (as well as an issued patent), but only in the hands of a transferee. Remember that the case of a 5 year amortization under IRC §174(b) is only for development costs expended by the taxpayer, which are not expensed under IRC §174(a) and which are not otherwise depreciable under §167, and thus NOT related to the purchase (and depreciation) of a patent application.
- (f) Where a patent is sold having a life of less than 20 years the difference between the sale and expense cases begins to diminish. For simplicity, a shorter period than 20 years is not considered because the effects are less pronounced. The regulations under §1.167(a)-3 provide that a patent is depreciable over the shorter of its legal life (the portion of the remaining 20 year period) or its useful life, and this comparison assumes that there is no special excuse justifying a life of less than 20 years. Corporate and individual rates are now NOT the same, with the top corporate rate remaining at 35%.
- (g) The Tax on an Unexpensed Portion is an amount of present tax Lent to Government to be repaid over 19 years. I used a net present value of return over time of 4.0%. For a \$1000 price, and where 5% of this amount can be currently deducted (as 1/20th of the value of the patent written off this year), the \$950 portion which could not be written off results in a tax of  $\$950 \times 39.6\% = \$376.20$ . The amount of \$376.20 would be paid back to the taxpayer in 19 payments of \$376.20 or \$19.80 per year. Using the 4.0% discount rate, this has a net present value of \$203.14. Subtracting this amount from the amount the taxpayer loaned the government,  $\$376.20 - \$203.14 = \$173.06$ . This is the amount the taxpayer “lost” by his interest free loan to the government. Of the initial \$1000 investment, the “loss” is 17.06%.
- (h) Similarly, a 15 year payback attainable under §197 would yield a loss of 13.6%. Thus, ignoring all other factors, a buyer would give at least an additional 13.6 - 17% to avoid having to capitalize.
- (i) A flat sale may be disadvantageous for the licensor where the licensee might have paid 17% more if the licensee did not have to amortize. A flat sale might be disadvantageous for the licensee because he risks his entire investment over the term of the patent for everything from a general business downturn to the arrival of new, substitute technology. Because of this risk, the licensee might offer to pay less; this, in turn, can harm the licensor.
- (j) A license based on productivity will potentially yield more profit to the licensor and less risk to the licensee. However, because the licensee can switch production to a

non-infringing technology, or can simply stop production and payments to the licensor, the licensee's risk is now minimal. The licensor has the ability to make more money if the product does well, but the licensor now bears the risk of change in technology and business downturns. From a tax standpoint, the money received by the licensor is the same, whether received as a lump sum or as a periodic stream of income on which the licensor will pay tax based on long term capital gain. The licensor pay tax based on long term capital gains regardless of whether the sale price is received as lump sum or periodic or both.

- (k) The even treatment normally afforded cash flow problems is distorted when one attempts to analyze an annuity stream based upon productivity of the patent. The distortions are due to (1) spreading of risk which is higher to the purchaser at sale, yet which yields higher returns as more sales are made, (2) product life cycle, which may yield high productivity in later years, thus diminishing or back-loading the comparison of an associated repayment of a loan by the government in the case of a purchase, and (3) the fact that a purchaser would probably pay less of a lump sum payment for the patent where he bears the risk of performance or where he is aware of the negative tax consequences of a straight sale. It is also worthy of note that licensing fees not tied to productivity (such as a minimum license fee which cannot be applied against a unit cost) will probably be required to be capitalized, even where other productivity based consideration is present.
- (l) In summary, the primary benefits that patent practitioners can give to their clients are to: (1) preserve the client's (holder) status, either by keeping title in the inventors, or at by holding the title in a partnership; (2) ensure that all entities will be entitled to take their IRC §174 deductions by keeping any partnership (in the game) of further exploiting the patents (intent and ability per the Kantor and LDL Research cases) in the event that the first license does not work out; (3) ensure that the licensor will have capital gains treatment by using IRC §1235 to make sure that an exclusive license amounts to a sale, (4) ensure that the licensee will be able to expense patent payments by using the Associated Patentees case to associate the purchase price with the productivity and use of the patent, and this will also likely result in a greater percentage for the licensor since the licensee risk of loss will have been reduced; (5) advise the clients that if the invention has not yet been reduced to practice, the investors still have time to acquire holder status by investing in the project before actual reduction to practice, and (6) load the benefit to the inventor(s) using either a sale by the inventor(s) as a group with less than 25% cumulative stock ownership in the buyer, or using stock appreciation in a corporation formed under IRC (351 where the inventors cumulatively own more than 50% of the stock.

## V. Tax Treatment of Copyrights

### A. DEDUCTION OF DEVELOPMENT EXPENSES

1. Although IRC §174 is drafted broadly to enable current expensing of research and experimentation, most copyrightable property will not qualify. Current regulations prohibit the deduction of expenditures for "literary, historical or similar projects." IRC §174, when read in conjunction with IRC §263A, requires capitalization of expenditures in connection with copyrightable subject matter.
2. In general, the first question to be asked in copyright is whether the copyrightable work is the pursuit of a hobby or non-business nature. If it is, IRC §183 can eliminate deductions related to production costs for the activity altogether, subject to deductions not in excess of the income from the project, if any. Other instances of deductibility are couched in terms of whether the

taxpayer is actively engaged in business, even where amortization is required. Where the project is abandoned, a deduction under IRC §165 is available.

3. Worse still for creators of copyright property, IRC §1221 excludes copyrights from capital asset status for taxpayers (1) whose personal efforts created the copyright property, (2) for whom such property was prepared or produced, and (3) in whose hands the basis of such property is determined for the purposes of determining gain from sale or exchange.

4. However, there has been a recent change to this statute for music copyrights only. According to previous law, all copyrights were classified as non-capital assets, such that gain on sale of copyrighted material was generally subject to taxation as ordinary income. Under IRC §1221(a)(3), exclusions from capital asset classification included:

A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, 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);

5. Currently, IRC §1221(b)(3) excepts from the IRC §1221(a)(3) exclusion certain self-created musical works:

Sale or exchange of self-created musical works.--At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged before January 1, 2011, by a taxpayer described in subsection (a)(3).

6. This recent change means that gain on sale or exchange of a self-created musical work has the potential to be taxed as capital gain at the preferential 0-23.8% rate enjoyed on a sale of patent or trade secret. However, the “instant capital gain” benefit that IRC §1235 bestows on patents and trade secrets does not apply here; instead, IRC §1223(3) appears to require a one-year holding period before the taxpayer can take advantage of the capital gain tax rate for the sale or exchange of a self-created musical work (like most regular capital assets).

7. An additional change which has taken place via the Tax Increase Prevention and Reconciliation Act of 2005 involves an election whereby a taxpayer can depreciate certain expenses incurred in creating or acquiring music or music copyrights according to the income forecast method. IRC §167(g) was amended to include the following special rules for certain musical works and copyrights:

(A) IN GENERAL.--If an election is in effect under this paragraph for any taxable year, then, notwithstanding paragraph (1), any expense which--

(i) is paid or incurred by the taxpayer in creating or acquiring any applicable musical property placed in service during the taxable year, and (ii) is otherwise properly chargeable to capital account, shall be amortized ratably over the 5-year period beginning with the month in which the property was placed in service. The preceding sentence shall not apply to any expense which, without regard to this paragraph, would not be allowable as a deduction.

(B) EXCLUSIVE METHOD.--Except as provided in this paragraph, no depreciation or amortization deduction shall be allowed with respect to any expense to which subparagraph (A)

applies.

(C) APPLICABLE MUSICAL PROPERTY.--For purposes of this paragraph--

(i) IN GENERAL.--The term 'applicable musical property' means any musical composition (including any accompanying words), or any copyright with respect to a musical composition, which is property to which this subsection applies without regard to this paragraph.

(ii) EXCEPTIONS.--Such term shall not include any property--

"(I) with respect to which expenses are treated as qualified creative expenses to which section 263A(h) applies,

"(II) to which a simplified procedure established under section 263A(j)(2) applies, or

"(III) which is an amortizable section 197 intangible (as defined in section 197(c)).

(D) ELECTION.--An election under this paragraph shall be made at such time and in such form as the Secretary may prescribe and shall apply to all applicable musical property placed in service during the taxable year for which the election applies.

(E) TERMINATION.--An election may not be made under this paragraph for any taxable year beginning after December 31, 2010."

8. One provision upon which some single-project taxpayers have attempted to rely is IRC §195. IRC §195 denies deductibility of start-up expenditures (i.e., expenditures incurred before business actually begins), but allows amortization of start-up expenditures over a 60-month period. The fact that the costs amortized under this provision would have been currently deductible for an ongoing business eliminates a majority of those who use copyrights. Under IRC §195(d), the taxpayer must elect to use the IRC §195 amortization at the time of filing of the first tax return after business begins. It is thus recommended that the taxpayer make a prophylactic IRC §195 election in the event that the IRS finds any of the expenditures to have occurred before business actually begins.

(a) Precedents in which IRC §195 have been most effective involve entities that are entering the publishing business and have paid the salaries or other service costs in the creation of books and articles. The passage of IRC §263A, which requires the capitalization of non-inventory costs but which usually relates to pre business start inventory, has created a presumption that most items of pre-business expense should be capitalized on their own account rather than amortized under IRC §195.

(b) Of course, where the taxpayer is in the business of creating copyright property, and where the copyright property is inventory for sale, and the taxpayer is already in business and current expenses of running the business are deductible. Even when the taxpayer is in business, specific project expenditures relating to the acquisition of copyrightable property have been held to be capitalizable rather than expensable. The dividing line would seem to be the relationship of the copyrighted work to the normal operation of the business. Where the business involves the operation of a copyrighted newsletter, it is doubtful that capitalization would be required. Where the business revolves about the creation of one or two major works requiring significant expenditures of time or money, capitalization would seem to be necessary. Most tax practitioners push the line as far as possible toward an inventory treatment, irrespective of a balanced inquiry as to the size of the business and relative size and importance of specific copyrightable projects.

(c) For amateur authors and creators who have gone beyond the IRC §183 hurdles of actually being in business for profit, there are other obstacles. The copyrightable property is not

an IRC §1221 (capital) asset in the hands of the creator, and the sale of the property by its creator (or one who commissioned its creation) will not result in capital gains treatment. The same is true for a taxpayer who obtained the property by gift or inheritance from the creator. Of course, a taxpayer who subsequently purchases the copyright property will purchase a capital asset. The purchased capital asset can then be depreciated under IRC §167 and other provisions of the Internal Revenue Code, and may be sold at profits eligible for capital gains treatment, provided that the 1-year holding rule is met and the copyright is not inventory. Recapture is had if there has been any depreciation.

- (d) Straight line depreciation can be utilized where a copyrighted work is not made for hire and can be taken over a 35 year period. This 35 year period represents the minimum time before an author or his successor can unilaterally terminate the transfer under 17 U.S.C. §203. The termination provision allows authors (and their heirs owning more than a 50% interest in the work) to (back out( of any agreement, transfer, or license. It was a compromise during the transition from a system in which a copyright was valid for a first period of about 28 years and renewable by the author for a second 28 years, where the author had primary rights during the second period and could thus “re-sell” his copyright during that period if he wished. Under current law, a copyright is good for the life of the author plus 70 years. If there are two authors, the copyright expires 70 years after the death of the last surviving author. Pseudonymous works expire 95 years from publication or 120 years from creation, whichever expires first. Currently, where the economic life can be shown to be less than 35 years, various other computational methods and procedures can be used to properly depreciate the copyrightable property.
- (e) Fragmentation by medium enables a copyright owner author to sell a copyright work in a single medium, while retaining rights in other separately identifiable media, even though such separately identifiable media are related to the medium sold. The copyright of an earlier version of a computer program can be retained while the copyright to a later version of a computer program can be sold in its entirety. An author of a novel can also create a screenplay based upon the novel and then sell both to a buyer. The buyer holds both as capital assets. Subsequently, the buyer can sell one without the other, and the sale will not be treated as a license even though the two are creatively related.
- (f) A subsequent sale may qualify for capital gains, but not if the seller is in the business of holding such properties for sale to customers. This is similar to the treatment of inventory, which is also not allowed to be capitalized. The authority for this is under both IRC §1221(1) (pertaining to stock in trade) and IRC §1231(b)(1)(A) & (B) (pertaining to the definition of property used in the trade or business).
- (g) A partial saving provision can be found in IRC §195. IRC §195 permits the amortization of the otherwise capitalizable startup costs over a period not to exceed 60 months. This provision will allow some accelerated cost recovery, but it is not nearly as favored as the tax treatment of patents. This provision can be used where the expenditures are for copyrights which are not major components of the property upon which the business is based. One example from the pertinent cases involves paying for articles for use in a publication; in this instance, articles purchased before the first issue is printed would be capitalized as a startup cost.
- (h) IRC §197, which became law in 1993, has provided some relief to trademark owners and also a measure of relief to certain patent and copyright owners. IRC (197 allows the amortization of any intangible acquired by the taxpayer after August 9, 1993 and held in the conduct of a trade or business within the meaning of IRC (212 (expenses incurred in the production of income). The period of amortization under IRC §197 is 15 years.

- (i) IRC §197 intangibles includes (1) goodwill; (2) going concern value; (3) work force in place, including composition and terms and conditions of employment; (4) business books and records, operating systems, or any other information base; (5) any patent, copyright, formula, process, design, pattern, know-how, format, or similar item; (6) any customer based intangible; (7) any supplier based intangible; (8) any other similar item; (9) any covenant not to compete; and, (10) any franchise, trademark, or trade name.
- (j) For copyright generally, IRC §197 excludes self-created intangibles, with the possible exception of trademarks (especially since the buyer is buying from someone else). Perhaps this provision helps to destroy a sale-lease back transaction. IRC §197 also excludes an interest in a film, sound recording, video tape, book or similar property, patent or copyright unless it is acquired in a transaction for the acquisition of assets constituting a trade or business. The rationale appears to be that the IRS does not want a sale of business and goodwill where the buyer loads goodwill value into the copyright to write it off after three years. This provision of IRC §197 creates a presumption that, where a business is sold, the real value will lie in the goodwill rather than a copyrighted computer program, and thus the write off will be limited to the 15 year amortization period for goodwill.
- (k) A copyright or patent owner who cannot use IRC §197 must capitalize the asset for the shorter of its legal or useful life. Since trademarks cannot be acquired without some vestige of the underlying business, all trademarks should properly be IRC §197 assets, and the fact that the trademark is self-created will probably not prevent the use of IRC §197 in depreciating the asset.
- (l) IRC §197 is intended to relate to software because IRC §197 excludes two types of computer software: (1) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified; and, (2) other computer software which is not acquired in a transaction involving acquisition of assets constituting a trade or business. IRC §197 also excludes computer software which is not owned by virtue of an exclusive license for the full term of the copyright (which would constitute a sale of the copyright or its fragment).
- (m) A further provision may also offer software developers relief. This provision has previously appeared in the statutes as IRC (167(f), but was repealed and is now reinstated as current IRC (167(f):
- (n) Treatment of certain property excluded from §197:
  - (1) Computer Software.
    - (A) In general. If a depreciation deduction is allowable under subsection (a)\* with respect to any computer software, such deduction shall be computed by using the straight line method and a useful life of 36 months.
    - (B) Computer Software. For purposes of this section, the term (computer software) has the meaning given to such term by section 197(e)(3)(B) (non-data type software); except that such term shall not include any software which is an amortizable §197 intangible.

\*§167(a) requires the property to be used in a trade or business or held for the production of income.
- (o) Clearly, if the software is not excludable from IRC §197, the 15 year amortization schedule of IRC §197 controls. IRC §167(f) is available where IRC §197 is not available. In some instances, neither IRC §167(f) nor IRC §197 is available. Where a custom piece of software is intended only for highly controlled licensing and use, and where the

software was not obtained in a transaction involving the sale of a business, neither IRC §167(f) nor IRC §197 was previously available. Where software is “off the shelf,” its product life is generally much shorter and therefore deserving of a shorter amortization period. Where a single product will undergo significant change each year, IRC §167 will enable a period of amortization most closely approximating a yearly expensing of the development costs. Consequently, developers of the shelf software are expected to rely more heavily upon IRC §167(f).

- (p) Taxpayers previously relied on Revenue Procedure 69-21 (now superseded by Revenue Procedure 2000-50), an early (1969) statement which analogized some software development to patent-type development and where the service previously stated that they would not disturb a taxpayer’s method of either current expensing of software development, or 5 year (60 month) amortization where it was (in accordance with rules similar to those of IRC §174 (relating to research & development)).( For development purposes, a taxpayer would prefer to expense the costs under IRC §174. However, Revenue Procedure 69-21 also contained a section entitled (Costs of Purchased Software,( and where the cost of the software is “separately stated” (remembering this was 1969 and software was possibly purchased with hardware more often at that time), the amortization period is stated as being (5 years or such shorter period as can be established by the taxpayer.( Since Revenue Procedure 69-21 is an invitation to hedge the 15 year amortization period for IRC §197 software, or at least to use it as evidence that 5 years should be the minimum time for amortization with any shorter life period for amortization to be shown by clear proof.
- (q) Rev. Proc. 2000-50 supersedes Rev. Proc. 69-21 for (non-informational data base( type programs and provides for current expensing of development costs. This can be deducted similar to the current expensing available under IRC (174(a), or such costs may be voluntarily amortizable in accord with rules similar to IRC (174(b) or over 36 months as outlined in IRC §167(f)(1). The definition section of Rev. Proc. 2000-50 distinctly excludes (data or information bases, customer lists, and client files, unless they are incident to an application program. The IRS is thus recognizing that data base contents are probably not patentable and that they should have applied the other rules on deductibility, such as the “ordinary and necessary” rules which will be specific to different types of businesses.
- (r) Where a copyright is purchased by itself, it may be depreciated over the shorter of its legal or useful life. Since the legal life of a work made for hire is 120 years from creation, this represents the longest legal life for a work. In the case of an ordinary copyright (rather than a work made for hire), the amortization period should initially be only 35 years because this is the time after publication at which the author or his successors can unilaterally terminate the transfer. The Associated Patentees case should also work for copyrights licensed based upon their productivity.

## E. WHAT IS IT WORTH? Deductions and Expenses

1. For copyright, there are several alternative methods to compare, including a straight line, 120 year amortization for works made for hire for straight purchases; a straight line, 35 year amortization for non-work made for hire copyrights for straight purchases (as well as a period after the first 35 years when it can be safely relied upon that heirs will not take the rights back); the 15 year amortization under IRC §197 for purchasers of software; the 3 year amortization under IRC §167(f) for developers of off-the-shelf software; expensing of the copyright purchase royalties where the license is based upon productivity; and, finally, expensing copyright developed internally.

2. Again, the value to the individual investor/holder who purchased the copyright from someone else is straightforward at the differential between the top ordinary rate of 39.6% and the 0-23.8% long term capital gains rate and including the effect of the cost of the property. Remember that this differential rises slightly where the individual is in the surtax region of income where his standard or schedule-A deductions and personal exemptions are being recaptured.
3. The risk of sale versus license value to the licensee is identical to that which was set forth for patents. However, since fragmentation is available, there should be less risk to a purchaser of a smaller portion of the copyright. There is also less risk to the licensor/seller because he is spreading the risk of performance among several people. The only comparison to be made here is straight purchase versus license based upon use, and this comparison considers that the seller is NOT the creator (except for music).
4. Using the analysis previously stated, it can be readily computed that the project cost for the 15 year writeoff under IRC §197 has a cost of an additional 13% of the cost of the asset, whereas a writeoff under IRC §167(f) has a cost of an additional 3% of the cost of the asset. This computation would take to account the 1/15, a portion written off in first year as having no discounted value, and NPV includes the first years payment. These additional costs represent the additional cost to the buyer of having to capitalize the sale price. Where the license sets forth payments based upon current use or productivity, the provisions of Associated Patentees enables the buyer/licensee to expense his yearly royalty payments. Thus there is roughly an 10% differential in project cost between classifying a piece of software as an off-the-shelf item under IRC §167(f) versus a specialty software item under IRC §197.
5. The even treatment normally afforded cash flow problems is distorted when one analyzes an annuity stream based upon productivity of the patent. The distortions are due to (1) spreading of risk which is higher to the purchaser at sale yet yields higher returns as more sales are made, (2) product life cycle, which may yield high productivity in later years, thus diminishing or back-loading the comparison of an associated repayment by the government of a loan in the case of a purchase, and (3) the fact that a purchaser would probably pay less of a lump sum payment for the patent where he bears the risk of performance or where he is aware of the negative tax consequences of a straight sale.
6. Assuming for a moment that minimum royalties could be used to approximate a flat cash flow to the seller/licensor, the above math should also be effective for a differential to be applied in the case of a straight sale versus a license agreement based upon performance. However, the above differential will mean more profit to the licensor (for which the individual licensor will pay less tax based on long term capital gain) subject to the licensor's assumption of the additional risk.

#### F. PATENTABILITY/COPYRIGHTABILITY OVERLAP

1. Regulation §1.1221-1(c)(1), which defines the exclusion from capital asset status, states that "for purposes of this subparagraph, the phrase 'similar property' does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law." Thus, property which is only patentable is exempted from the exclusions of IRC §1221 and is treated as a capital asset in the hands of the creator. Copyrights are excluded from capital asset status where created by the taxpayer. The State Street Bank case and Rev. Proc. 2000-50 has made the outcome favorable for developers who expend funds to get the software developed, but excludes asset treatment where the developer is the creator.
2. The rule clearly allows companies to deduct amounts paid to employees who are developing internal use software. Where the taxpayer is a programmer, he can deduct funds paid to others;



however, he will still be saddled with ordinary income upon sale of the software.

3. Earlier questionable strategies of foregoing copyright protection no longer make sense. A series of versions of the copyright can each be copyrighted, and the patent for the underlying idea can be patented, with sale treatment arising differently for the different rights sold. Patent will dominate, because someone who can make copies still cannot practice the invention embodied in the software copied. Licenses should set forth exactly what rights are being licensed, and allocation of sale moneys should be (properly) attributed to the sale of the patent rights to give better tax treatment to the inventor.
4. In cases where the developer will sell the patented or copyrighted product and retain ownership of the copyright and patent, the tax effect of owning a copyright or patent (or both) should be minimal because there is no sale and both the patent and copyright are being held for production of income. Patents are tax-favored, and attorney's fees expended in obtaining a patent are also expensible. Where a sale within the first two years is a likely occurrence, applying for a patent is a good investment in a tax strategy hedge because favorable tax treatment will be afforded even if the patent does not ultimately issue. Moreover, patents are also a good investment to protect the technology.
5. It should also be kept in mind that where a copyright is treated as a capital asset (where it was not created by the taxpayer and has a basis that was not determined in the hands of the taxpayer), the sale of a depreciated copyright may be subject to recapture for the depreciation in excess of the straight line depreciation, even where the seller can treat it as a long term capital gain. Some relief to copyright developers can be had under IRC §197 as outlined above.
6. In summary, the main benefits which tax practitioners can give to their clients are to (1) investigate whether the software is even narrowly patentable, and if so to file a patent application not only to protect the software but to bolster the ability to expense development costs where data is a significant part of the software; (2) evaluate the value of filing for copyright within 3 months after publication and preferably as early as the copyright program is operable, so as to constitute a work; (3) in a close case, structuring the license agreement to increase the likelihood of qualification under IRC §167(f) rather than IRC §197, such as by emphasizing that it is being acquired along with other assets constituting a business, or by reciting facts which show that the computer software is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified; (4) make certain to take advantage of fragmentation of copyright to insure that the seller is able to attain capital gain treatment by properly fragmenting the copyright and clearly stating the bounds of the sale/license to insure that fragmentation is recognized; (5) structure a license based upon productivity and use to save the licensee/purchaser from having to capitalize the purchase price/royalties (even if the seller/developer has to treat sums received as ordinary income); and, (6) structure licenses and sales which clearly treat the copyright-like rights separate, apart, and subordinate to the patent-like rights, to insure that the patent is not fragmented so as to lose the potential for capital gain treatment.

## VI. Tax Treatment of Trademarks

### A. WHAT IS IT WORTH? TRADEMARK EXPENSES CAPITALIZATION, SALE

1. Expenditures to develop, acquire and defend a Trademark cannot be properly expensed. Since a

- trademark can last forever, it has no determined life period over which to depreciate or amortize its cost. Costs of advertising which, in fact, develop the trademark are expensible, as is any other form of advertising under IRC §162.
2. Further, IRC §195, which allows the amortization of start-up costs, does not apply to expenditures for trademark development and acquisition. Even payments to a competitor to buy out their use of a name or to get them to contractually agree to avoid using a name are capitalizable.
  3. Expenditures for trademark development can be recovered when the trademark ceases to be used or when the trademark rights are sold. However, expenditures to challenge another's right to a trademark using litigation have occasionally been held to be expensible. Money expended to defend a trademark is capitalizable. Funds spent in challenging the trademark of another have sometimes been held to be deductible where it is shown that the main questions involved in the suit do not relate to either acquisition of a mark or an attempt to force someone else into abandonment so that the mark could be obtained.

## B. TRADEMARK SALE AND LICENSE TRANSACTIONS

1. Licensing revenues represent ordinary income to the recipient and are deductible to the payor. The sale of a trademark is treated as the sale of a capital asset by the seller. Payments to purchase a trademark are capitalized.
2. In some close situations, the grant of a perpetual right to exploit and use a trademark can be considered a sale. IRC §1253 was enacted to clearly distinguish a sale from a license. IRC §1253 states that "a 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."
3. Significant rights include (1) the right to disapprove of any [further] assignment of such interest; (2) the right to terminate at will; (3) the right to prescribe the standards of quality of products used or sold (or of services furnished) and the quality of equipment and facilities used to promote such products or services; (4) the right to require that the transferee sell or advertise only the product or services of the transferor; (5) the right to require that the transferee purchase substantially all of his supplies and equipment from the transferor; and, (6) 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 (IRC §1253(b)(2)). Any of the foregoing retained rights will be sufficient to re-characterize the payment as a license payment rather than a sale. A license payment is deductible by the licensee and includible as ordinary income of the licensor.
4. With respect to current deductions, the rule available in copyright and patent cases and derived from Associated Patentees has been codified as IRC §1253(d)(1), which provides that payments made during the year for trademark rights contingent on productivity, use or disposition of the trademark, or any amount which is paid as part of a series of equal payments no less frequently than annually, may be currently deducted. This is the only exception to the exclusivity of IRC §197 in allowing amortization of a trademark capital account.
5. IRC §197 has the greatest impact on trademarks because the capitalized amounts cannot be amortized outside of IRC §197 (except under IRC §1253(d)(1) for production or use). Copyrights can be amortized under IRC §197, but only where the copyrights were not created by the author or created as a work for hire for the taxpayer, or where the copyright is acquired in a transaction for the acquisition of assets constituting a trade or business. For patents, the more

lucrative treatment under IRC §174, which allows the alternatives of (1) expensing the development costs, (2) amortizing over 60 months, or (3) depreciating under IRC §167, are preferable to the 15 year amortization provided under IRC §197. Again, see T.D. 8865 (1/14/2000) for changes affecting trademarks.

### C. EFFECTS OF SELECTING A WEAK MARK

1. All of the above information indicates that a mark should be acquired so as to avoid both litigation and another's ability to use the mark legitimately. When a dictionary word is selected, the chances are relatively high that (1) someone else has chosen the same mark, or (2) if the trademark-related business is successful, others will have an incentive to imitate the mark using look-alike, sound-alike, or spell-alike variants.
2. There are many ways that the owner of a weak trademark can (and almost invariably will) lose money. For example, if the mark is descriptive, money spent advertising will boost competitors' sales more than one's own sales. If the mark is popular, a lawsuit will almost surely ensue, and costs to defend the mark are not deductible. It should be clear that where a weak mark is selected, there may be no funds left available upon which to sail into the sunset at a 0-23.8% tax rate at the end of one's working life. As a more detailed example, assume that a business earns \$1,000,000 in profits but has to spend \$1,000,000 on attorneys' fees to defend its trademark. Does the company break even? Absolutely not! The company will have to borrow \$340,000 to pay the tax on the \$1,000,000 in profit that it earned, and the \$1,000,000 it spent on legal fees will have to be "capitalized."

## VII. Tax Treatment of Trade Secrets & Know How

### A. Trade Secrets are Patent-Like

1. Trade secrets appear to have characteristics which are patent-like, yet which can also be treated like property under general principles of exchange of property. In some cases, the sale of property with potential patentability may come within IRC §1235, enabling the owner to realize capital gains on the sale of the property even when the property is held for less than a year. Remember that a complete sale of a trade secret, much like the sale of a patent, will prohibit the seller from practicing the trade secret. Sale of a trade secret followed by a non-exclusive license back to the seller would likely be re-characterized as a non-exclusive license from the seller to the buyer because the seller has kept the right to utilize the trade secret.
2. The ability to treat trade secrets and know-how as patent-like comes from the emphasis on development and the favorable treatment given to investment which occurs before the trade secrets and know-how are reduced to practice. In the landmark case *Gilson v. Commissioner*, 48 T.C.M. 922, a creator of 82 designs was allowed design patent tax treatment even though only two of the designs were patented. *Gilson* is also cited by some for the premise that, so long as copyright protection is not sought, the property may be treated as patent-like.
3. Other similar principles apply to the transfer of know-how and trade secrets. Where a taxpayer develops or collects and sells trade secrets in the course of business, ordinary income will arise under the inventory principle. In other cases, there may be an attempt to determine if there has been a sale or merely a license. As in the case of patents, the Internal Revenue Service requires a transfer of all substantial rights in the trade secret or know-how. However, because a trade secret can have an indefinite life much like a trademark, the transfer should be without any

term-of-years limitation. Of course, at such time that a trade secret becomes generally known, it will cease to exist.

4. With regard to fragmentation, the trade secret or know-how sold should be as complete as possible to enable an independent singular commercial exploitation. The contract of sale should recite what the buyer will be enabled to do, even perhaps in the form of a guarantee, to insure that the technology will be an enabling package. Much of the parallel treatment of trade secrets and patents stems from the fact that an invention is a trade secret until disclosed to the public. In many cases, especially chemical cases, the patent applicant may apply for patent, begin exploiting the invention as a trade secret, and then watch to see if competitors can reverse engineer it. Once the patent is allowed, if it is allowed, one or two years will probably have passed, and the applicant/trade secret owner will have a single opportunity to decide whether to (1) allow the patent to go abandoned and keep the invention as a trade secret, or (2) allow the patent to issue and destroy the trade secret through publication of the patent.

- B. Sale Requires the transferor to not only give up his rights, but to confer power in the transferee to sue. (Otherwise, it is a sharing and not a sale).

## VIII. Bankruptcy Treatment

- A. § 365 Executory contracts and unexpired leases:

1. § 365 (a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.
2. Generally an executory contract is a contract on which some measure of performance remains on BOTH sides of the contract. A note is often given as a non-executory contract upon which one side has completed its performance and thus performance of paying back the note is the only performance and it rests only on one side. So an executory contract is one upon which both sides have performance, such as ordering and paying for a minimum amount of goods each month.

- B. § 365(n) relates directly to intellectual property. § 365(n) :

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—

- (A) the trustee shall allow the licensee to exercise such rights;
- (B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and
- (C) the licensee shall be deemed to waive—
  - (i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and
  - (ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract or any agreement supplementary to such contract—

- (i) perform such contract; or
- (ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

C. Note that “intellectual property” is defined by 11 U.S.C. § 101-35A and that trademarks are not considered intellectual property under the bankruptcy code:

(35A) The term "intellectual property" means -

- (A) trade secret;
  - (B) invention, process, design, or plant protected under title 35;
  - (C) patent application;
  - (D) plant variety;
  - (E) work of authorship protected under title 17; or
  - (F) mask work protected under chapter 9 of title 17;
- to the extent protected by applicable nonbankruptcy law.

#### D. PATENT BANKRUPTCY RISK

1. Generally:

The bankruptcy code favors that which will maximize the value of the debtor's estate and, even if it means allowing the trustee to assign notwithstanding a provision in the patent license. In re Rickel Home Centers, Inc., 209 E3d 291,299 (3d Cir. 2000). This principle of federal assignability in bankruptcy of that which could not be assigned outside of bankruptcy can most directly harm non-debtor licensors. Profit maximization of licensor-debtors may tend to

generally increase the price of doing business for non-debtor licensees. Generally, non-exclusive licenses should not be assignable in bankruptcy without the licensor's consent, but case law exists on both sides of this question.

2. Licensee Bankruptcy:

A licensee may be able to keep using the technology if the debtor-licensee elects to retain the license rather than reject it, and especially where the licensor does not object. The licensor may or may not be able to receive full compensation where the debtor-licensee was in arrears pre-petition. Another factor may relate to whether the licensor can maintain control of the goods and services licensed inside a bankruptcy as well as outside of the bankruptcy. Another factor may be whether the license was more akin to more permanent licensee ownership and thus the ability to hold the license may be strengthened (for example, where standards setting is limited, or where there is some shared responsibility for control in the license).

Licensee rejection of the license may create damages in the licensor, much of which may be difficult to prove or which may be compensable for pennies on the dollar as prepetition debts, as rejection is deemed to have occurred a moment before the bankruptcy petition was filed. Thus, it may be that in a majority of instances, the licensor simply files a bankruptcy claim and that may be the end of it. Mounting an adversary proceeding in bankruptcy court to attempt to prove up special damages caused by a licensee may not make much economic sense.

3. Licensor Bankruptcy: (11 U.S.C. § 365)

Licensor bankruptcy presents a possibility for (a) acceptance of the license contract (with all of its attendant responsibilities), (b) rejection of the licenses and dealing with the technology in house (reunifying the monopoly), or (c) rejecting the lower performing licenses and accepting higher performing licenses.

Similarly, licensees that have licenses rejected by the licensor-debtor may (1) file a claim against the estate along with the other creditors or (2) elect to retain its rights under the contract as they existed at the time of bankruptcy filing (along with the obligation to continue paying under the license agreement, and waive right to setoff damages).

Limited to Old Technology: It is emphasized that the progression of technology for involuntary licensing under 11 U.S.C. § 365(n)(3) & (n)(4) contemplates technology limited to the state in which it had progressed up to the date of bankruptcy filing, and not later or ongoing developments.

4. One technique which has the *potential* to take the bankruptcy trustee out of the game is the giving of monthly licenses. In theory, the bankruptcy trustee should only be able to assert the same rights in a contract that the bankrupt would have; however if the trustee holds that a series of short licenses were not actually administered in that way and that the underlying license was defacto of a longer duration, this technique might not work. It would have a greater chance to work, and in fact might help with cash flow, if each payment was coupled with the execution of a new license.

E. TRADEMARK BANKRUPTCY RISK

1. Background and Mixed Cases

In *Sunbeam Products, Inc. v. Chicago American Mfg., LLC*, 2012 WL 2687939 (7th Cir. July 9, 2012), a recent case emphasized that a trademark license breach would enable the licensees to stake a claim for damages. It was a case that involved both patent and trademark rights, and so

the dual IP did little to help get a bright line test for the treatment of trademark rights.

The case of *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.* 756 F.2d 1043 (4th Cir 1985) established a “licensee loses rights when licensor rejects the license contract” rule. Congress later Added § 365 (n) (in 1988) to give licensees rights to keep their license as to IP (upon licensor bankruptcy), but the bankruptcy code “omits” trademark from the definition. Some treatises say that congress was set to add a trademark provision the next year, but was unable to get it done.

It should be remembered that trademarks, by their nature, are wholly different from patents in a way that centers around liability for ownership. Ownership of a patent is generally passive and carries no liability. Ownership of a trademark is a bit more active in that the owner is considered to be in a position to continually specify the nature and quality of any goods manufactured under the mark. Any problem with products sold in the marketplace will relate back to the trademark owner. I bring this up not to emphasize a statutory difference, but a practical difference in terms of the effect on the bankrupt estate. Note also that § 365 (n) does not appear to distinguish between exclusive and nonexclusive licenses.

A patent license is merely a promise not to sue the licensee. Once a patent license is executed, the licensor has no further duties. A trademark licensor has duties which include checking product manufactured, inspecting and approving the licensee’s manufacturing capability, proper use of the trademark, and in re-setting and changing manufacturing quality standards in accord with technologies of manufacture. There is a duty, possibly, in making pro-active changes and improvements as the best (and even average) newer manufacturing techniques and approaches become available.

## 2. Trademark Licensor Bankruptcy

Where the licensor is a debtor, he can accept or reject the license contract the same as any other executory contract. Where a licensor debtor is impaired and must resort to bankruptcy, it is clear that a trademark license is executory in nature and generally active. Licensor has to check licensee for compliance, and Licensee must generally report its activity under the license. If it is done correctly, there is a lot of interaction, discussion and negotiation. Unlike leases where the bankrupt lessor will be cutting off a passive future renter liability, the business of maintaining and servicing a trademark licensee will be more highly levered than an exchange of cash. It may be that a licensing operation may not only have a high cost and consequently a low ROI, but it may also tax the operational resources of the licensor to the point where it is a drain on the estate. It may be that significant employee time is required to administer the trademark licensing business unit. It may also be that it may or may not be vital to the licensor’s core business (associated with the mark) and the licensor may seek to shrink its operations and consolidate its trademark control & brand more precisely, or to sell it. I believe that the active nature of trademarks versus the lesser active nature of patents and other forms of intellectual property caused trademarks to be omitted from the “what is intellectual property list” of §101(35A).

## 3. Trademark Licensee Bankruptcy

Since there are no “special” executory contract “accept / reject” rights for licensees or licensors in bankruptcy, (since 365(n) applies only to licensor bankruptcies, and because trademark is not defined as intellectual property under the bankruptcy code) the licensee can accept or reject a license agreement like any other contract. However, because of the active nature of trademark licensing, the licensor can, at minimum, give the licensee a hard time on the issue of same problem of drainage on resources is had by the licensee. Even without legal action, the Licensor can change the licensor license technical requirements & standards for all licensees (which it should be doing in any event simply with the passage of time, changes in technology and changes in the markets.)

In essence, the licensor can increase the activities that the licensees must perform in order to provide the licensor further, real assurances that its overall market is moving in the right direction. If the licensee accepts the contract then any rejection by the licensor will be probably be treated as being in a sort of a perfunctory breach, entitling the licensee to damages.

Some commentators have cited *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir 1999) for the proposition that (1) the licensee can be kept from assigning the licensee's license to another party and (2) can prevent a debtor from keeping the contract in the ordinary course of business. *In re Catapult Entertainment, Inc.* was decided after the 1988 addition of 365 (n), but 365 (n) does not apply to licensee bankrupts. *In re Catapult Entertainment, Inc.* digs deep into the friction between 365(f) and 365(c) and thus may still be good law, but *In re Catapult Entertainment, Inc.* dealt with patents alone, and not trademarks.

It may also be that exclusive versus nonexclusive licenses may play a role in the outcome, particularly under trademark. A non-exclusive licensor may have hundreds of licensees, and each may be adjudged and ranked based upon performance, cash flow, legitimacy, and more. Licensors are in a constant state of policing its licensees and terminating the non-performers and replacing them with top performers. An exclusive license, where the licensor is bound to the licensee, and where the licensee will likely have a more equitable powers (more akin to ownership) will have a greater chances of having the license in the hands of licensee characterized more as a property than as a personal service. A trademark license where the licensee has more control and ownership "quasi-rights" than the licensor would and should be rare.

Conversely, where the licensor has reserved rights in the license to make adjustments in the performance of the licensee, and to set minute terms of the licensee's performance, it will have a lesser chance for either assignability or assumption of the contract. Some of the aspects of control that can be kept by a licensor might include specifying which of licensee's employees can be hired or fired, or who can be on, or off of the project relating to the license. The relationship might end up looking like more of a joint venture. After all, so long as the trademark owner has the responsibility of specifying the nature and quality of the goods, and the responsibility of rejecting aspects of the goods, services and perhaps performance of the licensee, doesn't it make sense that the licensor can either find grounds to terminate the licensee or can make the licensee's life so difficult that the licensee voluntarily gives up the license?

Other limitations may also arise. A license that includes many trademark lines, might be segregable between the lines being dealt with at the time of bankruptcy filing and those that were dormant. Failure of performance clauses which relate to an increased royalty rate for a declining volume of goods and services might also provide some automatic relief for the licensor regardless of licensee (and thus affect the value of the license to be debtor licensee). Conversely, where a trademark license monetizes all the expenses of the licensee's efforts, the ability of the licensor to make the licensee's life miserable might come at too high of a price, and the licensor may simply leave the license in place.

4. Assigning of the license by the non-debtor is a major effect, regardless of whether the licensor or licensee is in bankruptcy. The general or "Universal Rule" is that trademark licenses are not assignable without permission of then non-debtor party. The threat of assignment is probably the major factor that will cause the non-debtor party to withhold his permission. There is a discussion of *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir 1999), *infra*. Despite the fact that *In re Catapult* was a patent matter and not a trademark matter, it does stand for the proposition that the 9th circuit adopted the "hypothetical" rule which can defeat a bankrupt licensee even assuming a contract in bankruptcy by asking whether the assumed licence could be further transferred. This case holding focusses even more attention upon the effect of the



licensor's permission.

It would seem rare that a case will be encountered where a non-debtor licensor would be stopped from assigning a license. This is because:

- (1) a naked trademark assignment would constitute an abandonment of the trademark (not a bankruptcy-type abandonment, but a complete abandonment as to the world),
- (2) there is flexibility for a licensor to perform a corporate reorganization to split lines of business into separate businesses with independent, nonbankruptcy right to do so, followed by the sale of the spin-off entity,
- (3) The trademark owners has rights under TMEP § 1615.01 to divide the registration and which does not appear to be limited by the trademark class, but rather ownership of goods and services (but note that the requirement of change of ownership before division creates a "chicken and egg" limitation where pre-event planning may be slightly constrained), and
- (4) There is the inherent flexibility for the owner of the trademark, the controller of the nature and quality of goods to morph his set of trademark words and symbols over time to control the depth, shape, and extent of his trademarks, and thus any license to which the trademark owner was bound could be caused to diminish, while the trademark owner brings up and strengthens the value of other trademarks which are not licensed to the debtor licensee over time.

#### F. TAX TREATMENT OF LICENSE INCOME AND EXPENSES DURING BANKRUPTCY

1. Generally taxes must be filed during bankruptcy. Debtors filing under chapters 7, 11, 12, and 13 of the Bankruptcy Code must file all applicable federal, state, and local tax returns that become due after a case commences. §346 (k)(1) & (2). Failure to file tax returns timely or obtain an extension can cause a bankruptcy petition to be converted to another chapter or dismissed.
2. Creation of the Bankruptcy Estate. The filing of a bankruptcy petition creates the bankruptcy estate. The bankruptcy estate consists of property that belongs to the debtor as of the filing date. The bankruptcy estate property is used to pay the debtor's creditors.
3. Separately taxable estate for Chapter 7 and 11. The chapter 11 and 7 estates are the taxable entities for postpetition income 26 U.S.C §1398(e) & 11 U.S.C. §346(a).
4. Non-separately taxable estate for Chapter 12 and 13. Chapter The bankruptcy estate is not treated as a separate entity for tax purposes when an individual files a petition under chapter 12 (Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income) or 13 (Adjustment of Debts of an Individual with Regular Income)§1398(e) of the Bankruptcy Code. The individual should continue to file the same federal income tax returns that were filed prior to the bankruptcy petition. Chapter 13 reorganizations are not available to corporations or partnerships and are only available to individuals.
5. Separately taxable bankruptcy estates are also separate for state & local tax. Whenever the Internal Revenue Code of 1986 provides that a separate taxable estate or entity is created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of such estate shall be taxed to or claimed by the estate, a separate taxable estate is also created for purposes of any State and local law imposing a tax on or measured by income and such income, gain, loss, deductions, and credits shall be taxed to or claimed by the estate and may not be taxed to or claimed by the debtor. 11 U.S.C. §346(a)
6. Where there is no separate taxable estate debtor is responsible, but trustee must report locally. Whenever the Internal Revenue Code of 1986 provides that no separate taxable estate shall be created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of an estate shall be taxed to or claimed by the debtor, such income, gain, loss, deductions, and credits shall be taxed

to or claimed by the debtor under a State or local law imposing a tax on or measured by income and may not be taxed to or claimed by the estate. The trustee shall make such tax returns of income of corporations and of partnerships as are required under any State or local law, but with respect to partnerships, shall make such returns only to the extent such returns are also required to be made under such Code. The estate shall be liable for any tax imposed on such corporation or partnership, but not for any tax imposed on partners or members. 11 U.S.C. §346(b)

7. Transfers between the bankruptcy estates is normally a non-taxable event. For purposes of any State or local law imposing a tax on or measured by income, a transfer of property from the debtor to the estate or from the estate to the debtor shall not be treated as a disposition for purposes of any provision assigning tax consequences to a disposition, except to the extent that such transfer is treated as a disposition under the Internal Revenue Code of 1986. 11 U.S.C. §346(f).

8. Estate to Use Taxpayers Accounting Method. The estate in any case described in subsection (a)[bankruptcy created separate taxable estate] shall use the same accounting method as the debtor used immediately before the commencement of the case, if such method of accounting complies with applicable nonbankruptcy tax law. 11 U.S.C. §346(e)

9. 26 U.S.C §108 debt forgiveness income is inoperable by virtue of 11 U.S.C. §346(f).

10. Rate of interest on tax claims generally. If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law. In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed. 11 U.S.C. §501(e)

11. Married debtors on a joint bankruptcy each create a separate estate that must be treated as two separate entities for tax purposes even if both estates are jointly administered.

## IX. Miscellaneous Matters

### A. INTERNATIONAL LICENSING OF INTELLECTUAL PROPERTY

1. Introduction: People engaged in international licensing or sales of intellectual property have many considerations to address, such as the availability of credits or deductions for taxes paid to foreign countries, the taxation of U.S. source income to foreign persons, withholding and reporting obligations, the authority granted to the I.R.S. to allocate income and deductions among related parties, taxation of outbound and inbound transfers, and foreign tax laws. Typically, a transferor must consider whether to structure the transfer as a sale or license, determine whether there is an immediate or deferred imposition of taxes, and establish eligibility of a sale for long term capital gain treatment. A transferee must consider not only whether to structure the transfer as a sale or license, but must determine deductibility of the license payments as well as the eligibility, extent, and rate of amortization of the purchase price in a sales transaction.
2. International Agreements: When drafting international agreements, several considerations must be addressed: (1) place of royalty payments and determination of exchange rates between countries; (2) allocation of tax burdens; (3) governmental approval; (4) registration, notification or recordation of the transaction; (5) choice of law; (6) termination issues; (7) availability of arbitration; (8) applicable language; (9) definitions, and (10) treaty provisions between countries of use/residence.

3. A transferor will probably want payments to be made in his home country and in the currency of that country. However, the transferee will originally pay the transferor in the currency of its home country. Thus, there may be a need to prescribe a method to determine which currency to use and how the exchange rates between the currencies of each country will be established.
4. The agreement should set forth the allocation of tax burdens between the parties. A transferor would obviously try to prevent the decrease of his returns by tax burdens imposed on the transaction by the licensee's country. Furthermore, each party should look into whether there are any governmental approvals that are required before entering into the agreement. Some countries require governmental approval before cross-boundary payments are legally effective. It would be best for the transferor to include such an assurance by the transferee in the agreement.
5. Registration or notification of international agreements was created through antitrust concepts, such as in the European countries, although a national standardized treatment of the registration or notification is not possible. When an agreement is registered, it is sent to the appropriate agency and is reviewed with reference to applicable antitrust laws. Some countries require international agreements be recorded. Recordation of an agreement may be beneficial to a transferee to put third parties on notice of the agreement. Moreover, in some countries, recordation is required before the agreement is valid and enforceable in local courts.
6. A U.S. person will most likely favor U.S. law when drafting international agreements, but U.S. law may not be the best choice when licensing or selling intellectual property. If the property is used and located in the transferee's country, it may be best to select the transferee's country as the choice of law. Another option may be to have certain laws apply depending on certain criteria. However, a side consideration is to anticipate whether the country's government or laws may change, thereby changing the status of the parties or some part of the agreement. Although governmental action or changes in the law are difficult to foresee, clauses to deal with such changes should be addressed in the agreement. For example, a termination clause may be included to determine the status of the parties in such circumstances.
7. Each country has its own arbitration laws and should be researched accordingly. Moreover, each country has its own language, and the agreement will most likely be translated into each language. Due to the inherent differences in translation between languages, agreements may have subtle differences. One option might be to have the final agreement drafted in a neutral language chosen by all parties or have both agreements represent the final agreement, which would require the skill of bilingual counsels.
8. Finally, words have a variety of meaning to each person within each country. Thus, it is best to define important terms, no matter how simple, since it may impact the grant provided for in the agreement. For example, a utility model patent may differ in expiration dates for each country, or the foreign country may provide for more than one method to protect an invention. Thus, it is best to define the necessary terms in agreement.

## B. INTERNATIONAL VENTURING

1. A joint venture, depending upon how it is structured, can result in constructive ownership paths between the joint venturers to yield a controlled corporation and unexpected tax results. Due consideration should be given to control and to the formal requirements for the joint venture vehicle and whether it will be treated as a corporation, partnership, LLC or other entity under U.S. Law.
2. In closing, there is one thing you should never do internationally, and that is to transfer a patent into a foreign venture, particularly a corporation in exchange for stock. Domestically, under IRC

§351, when assets are placed into a corporation, there is no tax recognition on the theory that the property is merely changing form, and that its risk of loss, etc., has not diminished. As such, appreciated property, property subject to liability, and the like can be placed into a corporation in exchange for stock with no tax consequences to the contributor/shareholder. However, under IRC §367, any transaction described in IRC §332 (liquidation of subsidiaries), §315 (corporate formation), §§354 & 361 (corporate reorganizations), and §356 (additional consideration to or from a corporation), and any transaction where the property involved is an intangible results in the following:

- (1) The transferor of the patent is treated as having sold the patent for contingent payments based upon the productivity and use of the patent, and
  - (2) The transferor of the patent is treated as receiving amounts annually which are commensurate with the income attributable to the intangible (whether any money is actually received or not), and
  - (3) The amounts deemed received by the transferor are U.S. source income.
3. The worst scenario might involve a patent having a fair market value of \$5,000,000 and in which the inventor or inventor-corporation had a basis of \$100,000. If the monopoly on the process or product could be used to generate \$1,000,000 of royalty per year for 20 years, the patent transferor will be forcibly imputed to have an income of \$1,000,000 per year for 20 years, despite the fact that the patent has a fair market value of only \$5,000,000. To add insult to injury, all of the forced income from the transaction is U.S. source income, rather than foreign source income.
  4. If the patent were simply licensed to the foreign joint venture corporation, it would probably experience a low foreign tax rate of about 10 %, generate 100% foreign source income, and therefore provide an effective device for soaking up, or blending, foreign tax credits. If significant capital is needed to set up manufacturing operations, it should be borrowed abroad. The negative impact of using patents as seed capital for foreign corporations is so severe that any interest charges or other impact of alternate financing is acceptable.
  5. Additional filings under FBAR and FATCA are necessary if assets are held abroad.

## C. PRACTICAL SURVIVAL STEPS

### 1. PATENTS

- (a) Make certain that you have absolutely completed your design to the maximum manufacturing advantage. This insures that (1) your design is set to be manufactured at the lowest possible cost to yield the maximum profit, which, in turn, will give you, with an allowed patent, the best combinational competitive advantage; (2) no changes will be made to the design after the patent is filed (because if your patent protects a sub-optimal version that is located at a less than optimal profitable area, and if the claims allowed are not broad enough to clearly encompass the optimum, you effectively have no patent protection and a copy of your product as an infringing product which brushes( the outer limits of your patent - because your patent is not centered on your product - is more likely to invite an infringer to chance litigation). If you are not technically skilled enough to finish your product to this stage, we can provide you with a complete non-disclosure agreement to enable you to approach a reputable engineering house to complete the design. Remember that one who helps on the invention becomes an inventor, so the non-disclosure agreement will also include a clause which states that ownership of the aspects invented by the engineering firm are yours. With engineering firms which also manufacture, make certain you have included the clause which mandates that they (will

never do business even relating to the invention with anyone else. ( When a manufacturing firm produces their (simple( non-disclosure agreement, do not even think about signing it! The vast majority of these are set a short timer on the waiver of your rights. Remember that you are paying them to work for you!

- (b) Apply for a patent as fully as possible, with as many embodiments as possible, as many claims as can be supported, and as many range equivalents as can be articulated. Keep in mind what your needs are and match them with the practitioner preparing your application. Large law firms are for litigating and usually charge companies fees of significant magnitude. Choose a practitioner with a technical background which is not mismatched with your technology. If you have a chemical case, go to a practitioner with a background in chemistry and chemical engineering. If you have an electrical case, go to a practitioner with a background in electrical engineering. Most practitioners will suffice for a simple mechanical case. I acquired a master's degree in both electrical and chemical engineering so that I would be enabled for the most technical of understanding for the vast majority of the time. However, I know my limitations too-- if someone came to me with a complex gene splicing patent, I would send them to someone with a Ph.D. in Biochemistry, and there are more than a few of those type practitioners around.
- (c) Just before and right after you file your patent, your operating plan should be so detailed that you do not care whether you license your invention or not because both paths should have an abundant amount of net present value. If you do license, make certain you use the tax principles discussed above to create a sale and to lessen your tax to the 0-23.8% capital gains rate. Further, do not retain so many rights that the IRS would rule a "non-sale" had occurred. Finally, be sure to use the rule in the Associated Patentees case to boost your royalty by at least 12% in today's economy (and perhaps up to 50% by not only reducing the tax burden of the payor by eliminating his need to capitalize, but also in reducing his operating risk by only having to pay for units of production from which he benefits). I acquired an LL.M. in taxation primarily so that I could provide additional guidance to my patent clients who are just starting on their first project. By insuring that the correct steps are taken at the outset, money can be saved later on, especially tax dollars.
- (d) Within one year, apply to all foreign countries where you might have a chance to establish a market, or apply to all non-Patent Cooperation Treaty countries where you might establish a market in conjunction with the filing of a Patent Cooperation Treaty (PCT) application, followed by a Chapter II application 6 months later only if you are interested in the three to four countries for which Chapter II is an issue.
- (e) When the patent issues, you should immediately place the patent number on all articles directly related to the patent. As you make patentable improvements, and typically at intervals of not more than one year, usually from the anniversary date of your patent application filing date, file updated continuation-in-part patent applications. If filed just before your 1-year anniversary date, use the continuation-in-part as your foreign application to insure that your foreign filing has your most up to date inventive improvements. If all of your claims are allowed in the U.S., consider parallel prosecution in which you allow the claims initially found to be patentable, and file a continuation case to pursue and argue over broader claims not made in the first filing.

## 2. TRADEMARKS

- (a) Choose a name for your product or service which is: (1) not descriptive, (2) not suggestive (test: if you disclosed the mark to a stranger and they would be unable to guess

what goods and/or services the mark describes, you may have a good mark), (3) not a geographic or place name, (4) not a government symbol, flag, coat of arms, etc., (5) not a dictionary word. Keep in mind that the primary object of the game is not to be (cute, (catchy( or (sexy(, but to choose a vessel in which you can easily accumulate goodwill with the goal of making extra money on the sale of your business (especially at the 0-23.8% capital gains rate). Goodwill is virtually always assigned to the trademark, so if you have a weak or non-protectible mark, no buyer is going to pay you full value for your business, products, or services. This is about putting money in your pocket at the end of your work life; this is not about seeing how much money you can spend arguing with and litigating against other holders of cheesy trademark names.

- (b) Ideally, you will want to trademark the name by itself, the logo by itself, and where possible, you should separate the name from the logo on the goods. Name-logo combinations are very weak, and it is better to use a regular trademark to fully protect the name (sequence of alphabetic letters) and a second mark to protect the logo by itself, even if another name (or no name) is used in conjunction with it.
- (c) Avoid differential capitalization, it weakens the mark, and where combinations of words or parts of words are used it (telegraphs( the pronunciation and meaning. For example, TreeExam is the same as TREE EXAM, and would be descriptive for a tree surgeon's services. However, it is unclear whether the word TREEEXAM is "tree exam" or "treex am", or simply "treexam".
- (d) Beware of letting marketing and advertising companies choose your mark. Although they may provide good marketing and ad copy for what you pay them, it has been our experience that they are adept at finding obscure marks owned by other people. In one case, on the recommendation of a marketing company, we did 3 full searches; every one turned up an obscure record which would have cost the adopter thousands of dollars to litigate.
- (e) Litigation in trademark is never a good thing for a new adopter of a mark because everyone else in the world has greater rights than you do. You are creating a vessel to hold good will dollars. At the end of the day, when you cash out, no one cares what color your "goodwill bank" was. Additionally, the mark is NOT where you identify the product. The box or brochure has plenty of open space for that.
- (f) We spend the bulk of our trademark time urging potential new registrants not to make the above mistakes. Often, the telephone questioner will be held in the death grip of an obsession about someone else's mark or a descriptive mark. The former is like facing a well armed gangster while naked, while the latter is like putting your money and efforts into a bank where the back end already has a big hole blown in it -- your deposits probably will not be available when you try to make a withdrawal.
- (g) Remember, when you are starting out, you are the little guy and you have to carve a high quality niche for yourself. The product and quality you put into your product or service drives the good will. Even a goofy name will eventually take on the mantle of quality you instill in the product or service. But even the catchiest, sexiest name in the world can't save a poorly maintained product.

## X. A FEW CONSISTENT CASES IN THE LAST DECADE

This list of cases has not been checked to see if they have been overturned on appeal. Do not rely upon

these cases until or unless they have been Shepardized.

1. If you don't have a specific separate sale agreement and specific services agreement; and you did a patent assignment for \$1 it will all be ordinary income BARRY LEE FARRIS, Petitioner v. CIR (T.C. Memo. 2010-222 , October 12, 2010)
2. C&F developed a machine for homogenizing and separating food (4,731,006) and worked out some further trade secrets in developing a process (C&F process) for making precooked sausage that had the appearance and taste of home-cooked sausage. Patent was struck for violating the 1 year sale/commercial use bar. Damages for trade secret destruction were held to be ordinary (important because G&F was a chapter S corp): JOSEPH A. AND JUDITH FREDA, ET AL., v. CIR (T.C. Memo. 2009-191, August 25, 2009)

Lessons: (1) unless grantor promises to never use the secret, it will not be a sale, (2) trial attorneys never seem to think about the tax issues until its too late, (3) Plaintiff never established and case never held that the trade secret itself was destroyed. (Court could have ordered the defendant to cease use of the secret and could have possibly put the genie back into the bottle.)

3. Selling your ideas to related taxpayers. In a complete mess, investor and inventor form a first entity (July 1969), then later form a second entity (September 1970), and then transfer the patent rights to a second entity. Held, Garfield transferred patent rights to Mechanical Plastics Corp., he transferred those rights to a related person. Taxpayer's assertion that there was a "forbearance agreement executed in 1969, but he failed to produce it. Note: Patent No. 3,651,734 was filed July 10, 1969, but it was a continuation-in-part of a case serial No. 844,690 of April 23, 1969. NATHANIEL H. GARFIELD, CAROL GARFIELD v. CIR ( C.A. 2nd 07-2474-ag unpublished opinion, appeal from the tax court, tax court holding affirmed) ((prior case was T.C. Memo. 2006-267))
4. We learn (1) an investor needs to invest in a partnership before "IRS construction to practice" (my own term) meaning that it had to get investment before the invention was provable, rather than the "Patent Office" constructive reduction to practice which occurred with the first patent filing. (The facts don't indicate how much "invention" was done in the interim, but it may have likely been thin); (2) forming an entity and then dealing with another entity you own will not constitute arms length dealing, (3) when a 17 year patent issues in 1972, and expires in 1999, its not smart to continue trying to claim capital gains on your 2000, 2001 and 2002 tax returns ((although the Tax Court failed to pick upon this glaring point)); (4) If you can't become a holder, you had better be a partner holding title for at least a year.
5. Software and services agreement, even if it contains some trade secrets, can't be a sale unless the seller agrees not to ever use it again. In other words "exclusive" as to one industry, is not exclusive for sale purposes. VISION INFORMATION SERVICES, L.L.C., Petitioner-Appellant, v. CIR 419 F.3d 554 (C.A. 6th). Lessons Learned (1) Software, to get patent treatment should be contracted as if it were a patent and file a patent application, (2) Don't try to re-interpret agreements retrospectively to try and turn a salamander into a horse, it makes you appear silly.
6. Inside and outside of section 1235. An inventor invents and applies for patents; then 5 years later he sells to an entity of which he owns 8%; Held: he is not a related party and is entitled to capital gains. Cascade Designs, Inc., v. Commissioner & James M. and Jane I. Lea v. Commissioner. (T.C. Memo. 2000-58, February 23, 2000)

**INTELLECTUAL PROPERTY GENERAL OWNERSHIP & OPERATION TABLE**

Curt Harrington, Harrington & Harrington, P.O. Box 91719, Long Beach, CA 90809-1719; (562) 594-9784

<b>Property Type</b>	<b>Liability for Ownership</b>	<b>Title Recordation</b>	<b>Insurance Needs</b>
Patent or Trade Secret	Usually no liability for passive holding of a negative right. Contractual breach is possible where property is sold and duty is breached.	Patent title system is in the Patent & Trademark Office. No system for trade secrets, but an escrow can be used for evidence purposes. UCC filings are possible.	Offensive patent insurance to prosecute infringers. Defensive Insurance to protect business continuity (all in addition to business entity with commercial liability insurance.)
Copyright General-	No liability for passive holding of a negative right. Contractual breach is possible where warranty is breached.	Copyright Office has its own title system. Writers Guild of America has a secondary registration system for proof of authorship.	Where in business, you need a defensive copyright infringement insurance (all in addition to business entity with commercial liability insurance.)
Software, non Patentable	No muniment of title except for copyright. For non-created software, physical possession may indicate ownership (or theft).	Copyright Office has its own title system. UCC filings are possible. Escrow service can provide evidentiary assistance	Same as for Patent. Where less than a whole work may have been inadvertently obtained from others, a special policy is needed (all in addition to business entity with commercial liability insurance.)
Patentable Software	Same as for patents for patent ownership. Copyright ownership may coexist	Same as for Patents and Copyrights where applicable	Same as for patents but with concerns over copied software fragments as above.
Trademarks	Ownership = Liability for any problem with goods, since ownership is “right to control the nature and quality of the goods.”	Patent & Trademark has its own title system. UCC filings are possible, especially as a Trademark is its own capital asset.	A special “Advertising Clause” policy is needed (all in addition to business entity with commercial liability insurance.)



**INTELLECTUAL PROPERTY TAX TREATMENT TABLE**

Curt Harrington, Harrington & Harrington, P.O. Box 91719, Long Beach, CA 90809-1719; (562) 594-9784

<b>Property Type</b>	<b>Write Off Method</b>	<b>Capital Gain</b>	<b>Comments</b>
Patent or Trade Secret	Expense Immediately §174	Instant <b>long term</b> Capital gains under §1235 for inventors and holders ( or outside §1235 if held >12 mos.)	Best possible treatment. §174 expense is NOT RELATED to the patent asset, so <b>no recapture</b> . Sale outside §1235 has relaxed buyer ownership percentage rules.
Copyright General-	Capitalize Identifiable Projects: (1) 15 year write off if acquired in a business (§197). (2) otherwise write off over useful life.	Not available to creator or creator employer; Ok to others if held for >1 yr.	Where you create or employ someone to create a copyrighted work, you are the author and the sale will be ordinary income. (Except music)
Software, non Patentable	If held in trade or business for the production of income (§167(a)) ok to depreciate over 36 months, straight line, typically an off-the-shelf sale. Specialty software not held for production of income, depreciate over the shorter of copyright life or useful life.	No capital gains in hands of creator or creator's employer. If purchased, owner has fragmentation by medium right to sell off different media portions and keep others	If truly non-patentable, you should register within 3 months of publication in order to get valuable litigation rights such as statutory minimum damages and attorney fees.
Patentable Software	Expense under §174	Same as for Patents	IRS may want to characterize as software, but should be patent, especially if patent application exists.
Trademarks	Cap. acquisition & costs of defending. Amortize over 15 years if acquired after 9/9/93 (with some piece of business)	Capital gains if held for more than one year.	Sale of trademark name without more is an abandonment, every purchase/sale should include something else from the business.

2013 PATENT FEDERAL TAX CHART

Curt Harrington, Harrington & Harrington, P.O. Box 91719, Long Beach, CA 90809-1719; (562) 594-9784

	Hold for Income Production	Nonexclusive License, Nonpassive (not a sale)	Exclusive License, Passive (not a sale)	Sale by Exclusive License, Lump sum	Sale by Exclusive Lic. Productivity Based *
Ordinary Income	Ordinary Income after depreciation of patent (39.6%)	Ordinary Income, depreciate if purchased (39.6%)	Ordinary Income after depreciation (39.6%)	None	None
Gen.Business Deductions	Yes	Yes, but beware becoming a vendor.	Usually No, but may deduct contract costs	No	Usually No, but may deduct contract costs
Self Emp.Tax (2013 Limit= \$113,700)	If Mat'l Particip. 12.4% to limit; 2.9% unlimited	If Mat'l Particip. 12.4% to limit; 2.9% unlimited	No, but beware mixed contract	None	None
LT Cap Gain	No	No	No	1235 or 1+Yr Held	1235 or 1+Yr Held
Added costs to buyer	Buyer Expenses production costs	Buyer Expenses Royalty as paid.	Buyer Expenses Royalty as paid.	Lump Capitalization cost to buyer ~17%	<i>Associated Patentees:</i> buyer expenses royalty
Top Fed Tax Top SE Tax Top CA Tax Total Tax	39.6%+\$14,098se 02.9%+0.9% 13.3% 56.7%+\$14,098	39.6%+\$14,098se 02.9%+0.9% 13.3% 56.7%+\$14,098	39.6%+3.8% obama 0.0% 13.3% 56.7%	23.8% Cap Gain 0.0% 13.3% 37.1%	23.8% Cap Gain 0.0% 13.3% 37.1%
Comment	Corp. ownership ONLY where CERTAIN patent will not be sold.	Owner is "in business" & responsible for policing the market, & enforcing patent.	Licensor to verify Licensee activity; significant rights retained by licensee	Capitalization = Interest Free Loan to government. 10% cost @ 5.5% interest rate	Licensor can still hold title, but has to license substantially all rights for full term of patent.

Other Advantages: \* Where the license gives up enough of the owner's rights to be considered a sale, the patent need not be assigned, and the inventor owner keeps title and is thus more secure from a breach by the licensee.

COMPARISON OF \$1 & \$2 MILLION PER YEAR DOLLAR PATENT SALE INCOME ONLY			
SINGLE INVENTOR	CALIFORNIA	ARIZONA	NEVADA
TOP TAX RATE	13.3%	4.54%	0%
STATE CAP GAIN RATE <sub>(1)</sub>	13.3%	3.405%	0%
FEDERAL INCOME TAX RATE	39.6%	39.6%	39.6%
FEDERAL CAP GAINS RATE <sub>(2)</sub>	0% / 15% / 20%	0% / 15% / 20%	0% / 15% / 20%
INVENTOR W/\$1MILLION/YR SALE			
FEDERAL CAP GAINS TAX <sub>(3)</sub>	\$204,123	\$204,123	\$204,123
STATE CAP GAINS TAX	\$109,421 <sub>(4)</sub>	\$44,361 <sub>(5)</sub>	\$0
EFFECTIVE FEDERAL TAX RATE	20.41%	20.41%	20.41%
EFFECTIVE STATE TAX RATE	10.94%	04.44%	0%
COMBINED RATE	31.3%	24.85%	20.41%
Dollars Saved Compared to CA	-----	\$65,060	\$109,421
Tax Percentage Saved Compared to CA	-----	6.45%	10.94%
INVENTOR W/\$2MILLION/YR SALE			
FEDERAL CAP GAINS TAX <sub>(3)</sub>	\$442,123	\$442,123	\$442,123
STATE CAP GAINS TAX	\$242,421 <sub>(4)</sub>	\$89,761 <sub>(5)</sub>	\$0
EFFECTIVE FEDERAL TAX RATE	22.1061%	22.1061%	22.1061%
EFFECTIVE STATE TAX RATE	12.1211%	26.5942%	0%
COMBINED RATE	34.2272%	26.5942%	22.1061%
Dollars Saved Compared to CA	-----	\$152,660	\$242,421
Tax Percentage Saved Compared to CA	-----	7.63%	12.1211%
(1) Assets acquired after December 31, 2011 & 2015 exclusion is 25% 43-1022(28)			
(2) Capital Gains Rate based upon no ordinary income; includes 3.8% tax; single taxpayer			
(3) This case assumes Zero ordinary federal income; all money is Long Term Capital Gains			
(4) Includes the mitigating effects of lower rate tables; Ignores phase out of exemption credits.			
(5) Includes the mitigating effects of lower rate tables			

WAGES			
STATER	CALIFORNIA	ARIZONA	NEVADA
MINIMUM WAGE	13.3%		
EMPLOYER HEALTH BENEFITS PD	\$9.00/HR	\$8.05/HR	\$7.25/HR
NO EMPLOYER HEALTH BENEFITS	\$9.00/HR	\$8.05/HR	\$8.25/HR
OVERTIME			
EMPLOYEE EARNS MINIMUM	≥40h/wk ≥8h/dy	Fed ≥40h/wk	≥40h/wk ≥8h/dy
OVERTIME RATE (8-12)/12 <sup>+</sup>	1.5 x (\$9.00 <sup>+</sup> ) 2.0 x (\$9.00 <sup>+</sup> )	1.5 x (\$8.05 <sup>+</sup> )	1.5 x (\$10.87- \$7.25)
EXCEPTIONS	7th day of work is 1.5 x OT	N/A	Agree 4dys x 10hs
EMPLOYEE EARNS 1.5XMINIMUM			≥40h/wk
OVERTIME RATE	20.41%	20.41%	1.5 x (\$12.37 <sup>+</sup> - \$8.25)
STATUTE OF LIMITATION	4YRS	2YRS; 3Wilful	2YRS
EXAMPLES			
ONE FULL TIME EMPLOYEE	\$18,720	\$16,744	\$15,080
100 HRs/Yr WEEKLY OVERTIME	\$1,350	\$1,207	\$1,207
100 HRS/YR DAILY COMPED O/T	\$1,350	\$0	\$1,207
TOTAL STATE WAGES	\$21,420	\$17,951	\$17,494
EXAMPLES			
TEN FULL TIME EMPLOYES	\$187,200	\$167,440	\$150,800
100 HRs/Yr/EE WEEKLY OVERTIME	\$13,500	\$12,070	\$12,070
100 HRS/YR DAILY COMPED O/T	\$13,500	\$0	\$12,070
TOTAL STATE WAGES	\$214,200	\$179,510	\$174,940
SAVINGS		\$34,690	\$39,260
HOUSING (2000 SQ FT EXAMPLE)			
COST PER SQUARE FOOT	\$300	\$129	\$116
MORTGAGE COST @4% INTEREST	\$24,000	\$10,320	\$9,280
REAL ESTATE TAX	\$6000/Yr	\$2,580	\$2,505
TOTAL HOUSING ANNUAL	\$30,000/Yr	\$12,900/Yr	\$11,785/Yr

## Mini-Outline for Patent Workshop

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**CONFIDENTIALITY & PRIVILEGE:** You are warned that anything you state in a room in the presence of others is not privileged & that others who hear about your invention are NOT under obligation to not stealing it, nor use it for themselves, nor to give nor sell the information to others. **ALL QUESTIONS MUST BE OF A GENERAL NATURE AND YOU ARE WARNED NOT TO GIVE ANY DETAILS OF YOUR INVENTION!!!!!!**

**Warnings:** Never (1) provisional, (2) Micro entity unless tax return is provided & name is unusual enough to quickly search. Consider disclosing past income on record. (3) Don't assign your patent into an entity as you will probably lose §1235 tax rights & may lose the patent.

**Avoid Provisional Applications. They are bad because they:** (1) force a double decision & increased cost at 1 year mark. (2) Waste of additional filing fee. (3) If conversion is sought, newly added claims may be rejected for new matter. (4) If conversion is sought, a petition fee is required. (5) If conversion is sought, the USPTO may delay until past the point that foreign filing office requires priority document. (6) Article 4(A)2 of the Paris Convention states " Any filing that is equivalent to a REGULAR NATIONAL FILING under the domestic legislation of any country of the Union or under bilateral or multilateral treaties concluded between countries of the Union shall be recognized as giving rise to the right of priority." Is a provisional a "REGULAR NATIONAL FILING" ??? (7) When a potential licensee sees that you have only filed a provisional, he will know that you have penuriousness-based doubts about the viability of your invention. (8) If the invention is completely developed, there is no need for a provisional. (9) If the invention is not completely developed, two a regular patent filings & a continuation-in-part can provide much more flexibility in deciding to use & keep the first filing under conditions of (a) restriction (both technological & tax), (b) the need to have some inventions issue base solely upon the original filing (without trying to "subtract" text verbatim & lacking claims which would have been part of the disclosure. (10) Provisional filings delay ultimate issue of the patent by at least one year. (11) Perhaps the biggest statistical reason that provisionals are ineffective is that they contain less disclosure by a significant amount, whether or not you include the claims in counting for the omission. (12) Under First-To-File, the factor in (11) becomes doubly important as you cannot recover anything omitted under a patent filing as you might have been able to do under First-To-Invent. (13) Further, drafting & filing claims forces consideration of the scope of the invention & thus forces the drafter to think about what may have been left out. (14) An unethical firm might bait-&-switch a lower overall price based upon the \$500 savings in filing costs & charge additional & more at the 1-year conversion time, costing the client un-necessarily.

### STEPS YOU CAN TAKE

**Steps:** (1) Finish the invention ("If I ordered 100,000 units of product, would you know your cost of production to the penny?") Remember, you can get a patent on a item that you can make for \$100 & sell millions of them for \$5 each. A patented item can lose money. Gather every design approach, especially the approaches your competitors might use to circumvent the principles embodied in your patent, capture all design approaches in the patent application.

(2) Use a non-disclosure in conjunction with a patent filing, if you make contact with anyone before YOU decide to start publicizing the product. It has been known for potential licensees to PAY to view the patent application after signing a nondisclosure agreement.

(3) IDENTIFY YOUR TRADE SHOW. You will use it (A) to let you plan the timing of patent preparation & filing, & (B) 2-3 months after filing as a focal point to rally potential licensees & customers at a central location. Meeting with all your potential licensees / distributors under one roof at one time will tend to help you evaluate your markets. This will also combat the tendency for the inventor to become “mesmerized” when one person shows interest & to waste time waiting for them to act (which is exactly what they want-- they want: the longer they can “string the inventor along” without having the inventor actively explore other competitors & comparing the interest, they will tire an inventor out & cause the inventor to settle for far less than the inventor would take under high-energy, competitive circumstances. Meeting with all your potential licensees / distributors under one roof at one time will facilitate getting all the players in one place & let them learn of potential customers’ & each others’ interest in your product.

(4) Right after filing the case consider buying offensive & defensive patent insurance.

(5) Use the “newness” of the product to get as much free, news-type, advertising as possible, ESPECIALLY leading up to the trade show. Free new-type advertising may enable enlargement of potential licensee list. Also contact & make arrangements with as many potential licensees for the show as are possible.

(6) One possible approach at the show is to affirmatively enter the market, or, put another way, make it clear that you do not care whether your product is taken over by a licensee or not. This (A) helps you to focus on the product & not to become obsessed with one potential licensee, & (B) shows licensees that if the price is not right, that you would just as soon be in business for yourself. IF the licensees know that an inventor will never enter business, it will encourage them to lull the inventor into a “wait-sleep-coma.” The potential licensee will simply wait the inventor out, license the invention for pennies, or produce through a seemingly unrelated party.

(7) Evaluate any licensee offers with regard to exclusivity, tax ramifications, bankruptcy, future development, carrot or stick motivations, strong patent v. weak patent maneuvers, ability of the licensor to expand & improve the technology, payment of patent insurance, triggers to litigate, spin-off products & industries, patent divisibility, asset protection, & annual minimum royalties.

### **SETTING UP YOUR PRODUCTION & SALES**

(1) Form a protective entity such as LLC or C or S corp. (2) Consider the location requirements in light of sales tax potential & avoid California’s sales tax traps. (3) Consider multiple corporations & segregating a real assets company from the sales & marketing company & possibly a third company to hold trademarks. (4) Consider your contracts & whether or not you subject yourself to other jurisdictions. (5) If manufacturing occurs elsewhere, consider steps taken to insure that your item is not “overproduced” & sold out the back door to competitors & that the item might (a) show up in the U.S. as grey market goods, or (b) overseas as directly competitive goods (audits, secret internal codes, production run numbers, identifiable “production lots” of incorporated components) (if you surrender production details, you will lose control) . (6) Consider the extent that you wish to integrate & protect trademarks, trade dress, device housings to force competitors to re-design their knock-offs. (7) Consider a mixed strategy of licensing income at a cheap tax rate combined with a product production entity/function in order to maximize deduction of expenses.

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