PATRICIA ANN METZER

Patricia Ann Metzer is with Vacovec, Mayotte & Singer LLP in Newton, Massachusetts. Her practice focuses on tax issues as they affect businesses, individuals and tax-exempt organizations.

She received her B.A., with distinction, from the University of Pennsylvania and her LL.B., cum laude, from the University of Pennsylvania Law School and has served as Associate Tax Legislative Counsel for the United States Treasury Department.

Miss Metzer has taught the Taxation of Intellectual Property and Other Intangibles at the Graduate Tax Program of the Boston University School of Law. She has lectured on the tax laws affecting intellectual property for the Boston Patent Law Association and past Advanced Licensing Institutes sponsored by the Franklin Pierce Law Center. She is also the author of numerous articles and texts on taxation and is a nationally recognized lecturer on tax issues affecting businesses and tax-exempt organizations.

Miss Metzer is a fellow of the American College of Tax Counsel and a member of the Advisory Board for the Tax Management *Corporate Tax and Business Planning Review*, and is on the Authors' Panel of the *Journal of Passthrough Entities*. She has served as a Member of the Council of the Taxation Section of the Massachusetts Bar Association, as Vice Chair-Publications of the Tax Section of the American Bar Association and a member of its Council, Chairman of the Boston Bar Association's Section on Taxation, and a member of the Advisory Committee of the N.Y.U. Annual Institute on Federal Taxation.

255 WASHINGTON STREET, NEWTON, MASSACHUSETTS 02458 (617) 964-0500

FEDERAL INCOME TAX LAWS AFFECTING THE ACQUISITION AND TRANSFER OF INTELLECTUAL PROPERTY

(Miss) Patricia Ann Metzer
Vacovec, Mayotte & Singer LLP
Newton, Massachusetts

Franklin Pierce Law Center
Thirteenth Annual Advanced Licensing Institute
July 15, 2004

(Outline Date: June 1, 2004)

GENERAL

I. **Goals**.

A. From a tax perspective, businesses and individual taxpayers who acquire (by way of development or otherwise) or dispose of intellectual property want to secure the most favorable tax results.

B. Ideally, the consideration received by a transferor will be taxed at the lowest possible rates or not at all, while the costs incurred by a developer and the consideration paid by a licensee or assignee will be deductible in full on a current basis.

C. Also, ideally, a transferor will not have "phantom" income, resulting in more income subject to tax than anticipated.

D. Finally, in an ideal world, if any party to the transaction lives or transacts business abroad, no adverse tax consequences will thereby arise.

© 2004 by Patricia Ann Metzer
All rights reserved

II. **Variables**.

A. The actual tax consequences of the acquisition or transfer of intellectual property depend upon a number of variables. See in this regard the Discussion Paper released by the Treasury Department on November 21, 1996 entitled "Selected Tax Policy Implications of Global Electronic Commerce."

B. Initially, it is important to know the kind of intellectual property – that is, its character for tax purposes. For example:

1. Is it a patent, a copyright, know-how, computer software, or a trademark?

2. In the hands of the transferor, is it a capital asset or inventory-type property?

3. In the hands of the transferee, is the property depreciable?

C. Secondly, the parties to a transaction involving a transfer of rights in intellectual property must determine the nature of the transaction. Specifically:

1. Does the transferor retain a substantial interest in the intellectual property?

2. Is the transferee of the intellectual property related to the transferor?

3. Does the transaction involve a payment of compensation for services rendered?

D. Finally, the tax consequences of the transaction will often depend upon the nature of the consideration paid or received. For example:

1. Is the consideration to be paid in a lump sum or in installments?

2. In the case of an installment sale, is there stated interest?

3. Are payments contingent on productivity or sales?

4. Is an arm's-length amount to be paid for the intellectual property?

5. Are expenses being prepaid?

6. Are the payments sourced in the United States or abroad?

ACQUIRING INTELLECTUAL PROPERTY, OTHER THAN FROM A RELATED PARTY

I. **Overview**.

A. There are three common ways in which intellectual property is acquired – that is, it is developed by the taxpayer, it is licensed from a third party, or it is received by way of assignment from a third party.

B. A taxpayer who wants to develop or otherwise acquire intellectual property is concerned about the deductibility of the acquisition costs under the tax code.

C. Moreover, if the taxpayer has foreign operations, it will be important to know whether the costs are sourced in the United States or abroad.

D. In addition, if the costs are paid to a foreign person, the acquiring party must determine whether or not U.S. income taxes need be withheld from the payments.

II. **Developing One's Own Intellectual Property**.

A. Deductibility of Research and Experimental Expenditures.

1. Historically, the tax code has included special provisions benefiting taxpayers who develop their own intellectual property. Probably the best-known provision is that dealing with the deductibility of research and experimental expenditures.

2. Normally, capital expenditures cannot be deducted currently. They must be added to basis and may or may not be amortizable or deductible over time. See Int. Rev. Code §§ 263(a) and 263A.

   a. Section 263A, the so-called uniform capitalization provision, requires a taxpayer to capitalize all direct and allocable indirect costs of tangible (but not intangible) personal property produced by the taxpayer for use in a trade or business or an activity conducted for profit.

   b. Under Section 263A, tangible property includes a film, sound recording, videotape, book, or similar property. See Treas. Reg. § 1.263A-2(a)(2).

3. However, Section 174 of the tax code gives taxpayers two basic optional ways to treat so-called research and experimental expenditures that are incurred in connection with a trade or business and that are reasonable (see Int. Rev. Code § 174(e), added by the Revenue Reconciliation Act of 1989) under the circumstances. The uniform capitalization provisions do not apply to such research and experimental expenditures. See Int. Rev. Code § 263A(c)(2); Treas. Reg. § 1.263A-1(e)(3)(ii)(P) and (iii)(B). See also Treas. Reg. § 1.263(a)-4(b)(4), excluding such research and experimental expenditures from coverage under the recently promulgated regulations governing the capitalization of intangibles.

   a. The expenditures can be deducted currently in full (Int. Rev. Code § 174(a)(1)) or, if they do not relate to depreciable property, they can be amortized ratably over a period of not less than 60 months, beginning with the month in which the benefits from them are first realized (Int. Rev. Code § 174(b)(1)).

b. Hence, amortization is available only during periods when there is no property resulting from the research activities that has a determinable useful life. For example, a taxpayer who develops a process and begins to deduct the attendant research and experimental expenses over a period of 60 months, beginning with the date on which the taxpayer first benefits from marketing products that result from the process, must stop amortizing all unamortized amounts (and depreciate them instead) once the process is patented. See Treas. Reg. § 1.174-4(a)(2) and (4) and the discussion of patent depreciation later in this outline.

c. An election to amortize can be limited to a particular project (see Treas. Reg. § 1.174-4(a)(5); I.R.S. Private Letter Ruling 9830030, dated April 28, 1998, dealing with specialized software development payments made to third parties). With respect to whether an election to expense can be limited to particular types of research and experimental expenditures (see I.R.S. Private Letter Ruling 9552048, dated October 2, 1995, dealing with legal fees incurred in securing a patent). Cf. Revenue Ruling 58-74, 1958-1 Cum. Bull. 148.

d. Under most circumstances, a taxpayer's election, once made, is binding – i.e., it can be changed only with Internal Revenue Service consent. Int. Rev. Code § 174(a)(3) and (b)(2). See I.R.S. Technical Advice Memorandum 9707003, dated October 31, 1997, and I.R.S. Private Letter Rulings 9726022 through 9726028, dated April 1, 1997. With respect the need to make an election to expense on an original (in contrast to an amended) return, see I.R.S. Private Letter Ruling 6603315940A, dated March 31, 1966.

e. However, an individual who chooses to expense his research and experimental expenses is later permitted to elect, without the consent of the Internal Revenue Service, to amortize some or all of his subsequently incurred expenses over a period of 10 years. If he does so, he will avoid any adverse impact under the alternative minimum tax provisions, pursuant to which an individual's alternative minimum taxable income must be determined by amortizing his research and experimental expenditures ratably over the 10-year period beginning with the taxable year in which they are made unless they relate to an activity in which he materially participates. See Int. Rev. Code § 56(b)(2), as amended by the Revenue Reconciliation Act of 1989; § 59(e); and, with respect to the binding nature of the election, I.R.S. Technical Advice Memorandum 9607001, dated October 31, 1995, and I.R.S. Technical Advice Memorandum 9746002, dated August 1, 1997 (dealing with the shareholder of an S corporation).

f. Note that, as written, the provisions of Section 56(e) are available to corporations as well as individuals. See I.R.S. Private Letter Ruling 200117006, dated January 17, 2001, and I.R.S. Field Service Advice 200122005, dated February 7, 2001.

4. Whatever election a taxpayer makes, prepaid research and experimental expenditures may remain non-deductible until the research and experimental work is actually performed. See Treas. Reg. § 1.461-1(a)(1) and (2); I.R.S. Private Letter Ruling 8939004, dated June 22, 1989; cf. Treas. Reg. § 1.263(a)-4(d)(3). As to an accrual basis taxpayer and investors in a tax shelter, see Int. Rev. Code § 461(h) and (i). With respect to payments made with borrowed funds repayable out of license fees, see I.R.S. Private Letter Ruling 9244021, dated July 13, 1992, and I.R.S. Private Letter Ruling 9249016, dated September 8, 1992.

5. The regulations define research and experimental expenditures as research and development costs in the experimental or laboratory sense. Treas. Reg. § 1.174-2(a)(1). This particular language has been in effect since 1957, although an updated definition was published in the *Federal Register* on October 3, 1994.

   a. Research and experimental expenditures include costs incident to the development or improvement of a product and the cost of obtaining a patent, such as attorneys' fees expended in perfecting a patent application.

   b. The cost of research performed by a third party under contract can qualify. Treas. Reg. § 1.174-2(a)(8).

   c. However, qualified costs do not include the cost of acquiring another person's patent or process (Treas. Reg. § 1.174-2(a)(3)(vi)) or the cost of obtaining foreign patents on inventions covered by U.S. patents and patent applications owned and developed by others (Revenue Ruling 66-30, 1966-1 Cum. Bull. 55). See also I.R.S. Technical Advice Memorandum 9707003, dated October 31, 1996, describing the trade or business requirement.

   d. In addition, qualified costs do not include the cost of acquiring depreciable property used in research activities. See *Ekman v. Commissioner,* T.C. Memo, 1997-318, 99-1 U.S.T.C. ¶50,580 (6th Cir. 1999). See also I.R.S. Field Service Advice 200207006, dated November 1, 2001, dealing with software products used in research or experimental activities.

6. Under regulations proposed in 1989, expenditures incurred after the point a product met its basic design specifications normally would not have qualified

as research and experimental expenditures, unless the expenditures related to modifications in the basic design made to cure significant defects in design or to reduce costs significantly or to achieve significantly enhanced performance. Proposed Treas. Reg. § 1.174-2(a)(1) (1989). This time-line approach was deleted from the definition of research and experimental expenditures proposed in March of 1993. Now, under the updated definition published in final form in 1994:

a. Amounts that a taxpayer spends to discover information that will eliminate uncertainty concerning the development or improvement of a product will qualify if the information already available to the taxpayer does not establish (i) the capability or method for developing or improving the product, or (ii) the appropriate design of the product. For this purpose, the nature of the product or improvement and the level of technological advance are not relevant. Treas. Reg. § 1.174-2(a)(1).

b. The cost of testing to determine whether the design of a product is appropriate, in contrast to mere quality control testing, can qualify as a research and experimental expenditure. Treas. Reg. § 1.174-2(a)(3)(i) and (4).

7. At present, the costs of developing computer software (whether or not it is patented or formally copyrighted) can be treated like research and experimental expenditures. See Revenue Ruling 71-248, 1971-1 Cum. Bull. 55; I.R.S. Private Letter Ruling 9551002, dated September 14, 1995. But see I.R.S. Technical Advice Memorandum 9449003, dated August 25, 1994, where the Internal Revenue Service concluded that the taxpayer had purchased (not developed) computer software programs for computer games.

Similar conclusions are reflected in I.R.S. Field Service Advice 199930016, dated April 27, 1999. See also Treas. Reg. § 1.263(a)-4(b)(3)(iv).

a. Under a 1969 revenue procedure, a taxpayer who elected to amortize, rather than immediately deduct, computer software development costs could do so over five years from the completion of development or over a shorter period where the developed software was shown to have a shorter useful life. Revenue Procedure 69-21, 1969-2 Cum. Bull. 303.

b. The 1969 revenue procedure has now been superseded by Revenue Procedure 2000-50, 2000-2 Cum. Bull. 601, permitting a taxpayer (i) to expense computer software development costs, (ii) to amortize them ratably over 60 months from the completion of development, or (iii) to amortize them ratably over 36 months from the date the software is placed in service. The preamble to recently promulgated Treas. Reg. § 1.263(a)-4 indicates that taxpayers may continue to rely on this revenue procedure until separate guidance is issued. 69 Fed. Reg. 436, at 440.

c. This is consistent with the fact that a taxpayer can now depreciate (under Int. Rev. Code § 167(f)(1)) the cost of depreciable computer software to which the tax code provision dealing with the amortization of intangibles (Int. Rev. Code § 197) does not apply. The depreciation period is 36 months from the date the property is placed in service. Thus, the final regulations under this provision (Treas. Reg. § 1.167(a)-14(b)(1)) prospectively modify the approach taken in the 1969 revenue procedure, to permit a taxpayer who develops depreciable computer software in-house to amortize the development costs ratably over a period of 36 months, beginning with

the month in which the computer software is placed in service. Note that Section 197 does not apply to self-created computer software. See Int. Rev. Code § 197(c)(2) and (e)(3).

d. Some concern has been expressed about the applicability of the uniform capitalization rules of Section 263A to the costs associated with the development of computer software, since the regulations define tangible personal property to include "video tapes . . . and other similar property embodying words, ideas, concepts, images, or sounds." Treas. Reg. § 1.263A-2(a)(2)(ii). However, Treasury Decision 8482, 1993-2 Cum. Bull. 77, at 81, confirms that so long as Revenue Procedure 69-21, *supra*, remains in effect, taxpayers will not be required to capitalize computer software development costs. See also the preamble to Proposed Treas. Reg. § 1.174-2(a)(1), appearing at 1993-1 Cum. Bull. 904.

e. Note that in 1997 the Internal Revenue Service announced its position that Year 2000 software update costs (i) could generally be treated in the same way as software development expenditures, but (ii) normally would not qualify for the research credit. Revenue Procedure 97-50, 1997-2 Cum. Bull. 525.

f. However, the Internal Revenue Service may treat web site development costs as ineligible for the special treatment afforded computer software development costs. See *BNA Daily Tax Report* No. 222, at G-2 (Nov. 16, 2000).

8. In the past, the tax code has permitted a taxpayer to claim a research credit. To avoid a double benefit, the deduction otherwise allowed for research and experimental expenditures must be reduced by any research credit available with respect to these expenditures, unless the taxpayer irrevocably chooses to

reduce the credit by the taxes deemed saved by not offsetting an amount equal to the credit against otherwise allowable deductions. Int. Rev. Code § 280C(c).

9. With respect to the ability to increase the assets of a controlled foreign corporation by the research and experimental expenditures that it incurs over its three most recent taxable years for purposes of determining whether the passive foreign investment company (PFIC) provisions of the tax code apply to its U.S. shareholders, see Int. Rev. Code § 1298(e)(1), added by the Omnibus Budget Reconciliation Act of 1993, as well as the discussion of this provision later in this outline.

B. Allocating Research and Experimental Expenditures Between Domestic and Foreign Activities.

1. Since a domestic taxpayer with foreign source income may be taxed both in the United States and abroad on that income, the tax code permits a domestic taxpayer to reduce his or its U.S. tax liability to reflect the income taxes (but not, for example, any value-added taxes) that the taxpayer pays abroad.

a. A domestic taxpayer either may deduct for U.S. tax purposes the income taxes that the taxpayer pays abroad (Int. Rev. Code § 164(a)) or, subject to many limitations, may credit these taxes against his or its regular U.S. tax liability (Int. Rev. Code § 27). See Int. Rev. Code § 59(a) dealing with the alternative minimum tax foreign tax credit.

b. If a taxpayer chooses the credit instead of the deduction, the credit for foreign taxes paid on income of the same kind – i.e., which falls within a particular foreign tax credit basket – cannot exceed that proportion of the taxpayer's total U.S. tax liability, which the taxpayer's taxable income from sources outside the United States

within that foreign tax credit basket bears to the taxpayer's entire taxable income for the same year. Int. Rev. Code § 904(a) and (d). Hence, the taxpayer must determine the source of the items of gross income and of the deductions shown on the taxpayer's U.S. tax return, in order to determine the source of the taxable income shown on the return. With respect to the foreign tax credit basket to which patent royalty income belongs, see *American Air Liquide, Inc. v. Commissioner*, 116 T.C. 23 (2001), aff'd, 2002-2 U.S.T.C. ¶50,628 (9th Cir. 2002).

2. If a taxpayer with foreign operations elects the foreign tax credit and also elects to deduct research and experimental expenditures, these expenditures must be apportioned between the taxpayer's U.S. and foreign source income within the class of gross income to which the taxpayer's product research activities are related. The allocation rules now in effect have a long history.

   a. After years of uncertainty, allocation rules (Int. Rev. Code § 864(f)) were added to the tax code by the Revenue Reconciliation Act of 1989. These rules superseded that portion of Treas. Reg. § 1.861-8 (promulgated in 1977) dealing with the allocation of research and experimental expenditures, but only with respect to a taxpayer's first two taxable years beginning after August 1, 1989 and during the first six months of a taxpayer's first taxable year beginning after August 1, 1991. Int. Rev. Code § 864(f)(5), as amended by the Revenue Reconciliation Act of 1990 and the Tax Extension Act of 1991.

   b. Thereafter, effective June 23, 1992, the Internal Revenue Service announced that it would not require a taxpayer to apply Treas. Reg. § 1.861-8(e)(3) during the last six months of the taxpayer's first taxable year beginning after August 1, 1991 and during the

immediately following taxable year, provided that the taxpayer used a prescribed transitional method of allocation based upon the expired tax code provision (Revenue Procedure 92-56, 1992-2 Cum. Bull. 409). The Omnibus Budget Reconciliation Act of 1993 reinstated Section 864(f), but only for a taxpayer's first taxable year (beginning on or before August 1, 1994) following the last taxable year to which Revenue Procedure 92-56 could have applied. See I.R.S. Field Service Advice 199918027, dated May 7, 1999.

c. To date, Section 864(f) has not been extended, although the Administration has in the past supported a revenue-neutral extension of this provision. Thus, Treas. Reg. § 1.861-8(e)(3) applies in taxable years beginning after August 1, 1994. However, proposed changes in this regulation were published in the *Federal Register* on May 24, 1995 and have since taken effect.

d. With respect to the allocation of research and development expenses between a parent corporation and its export subsidiaries for a different purpose, see *The Boeing Co. v. United States*, 537 U.S. 437 (2003).

3. Pursuant to the regulations now in effect (Treas. Reg. § 1.861-17, generally applicable in taxable years beginning after 1995), which are based in part on the Treasury Department's study entitled *The Relationship Between U.S. Research and Development and Foreign Income*, a study that was issued on May 19, 1995:

a. Expenditures made solely to satisfy the legal requirements of a governmental entity with respect to the improvement or marketing of products or processes are allocable to the geographic area within which the test results are reasonably expected to generate all but a *de minimis* amount of gross income.

b. Under the sales method, a taxpayer may apportion 50% of the taxpayer's other research expenditures to U.S. (or foreign) source income if over 50% of the taxpayer's research activities are conducted in the U.S. (or abroad), and the balance of the expenditures must then be apportioned based on sales.

c. Alternatively, a taxpayer can choose the optional gross income methods of apportionment pursuant to which 25% of the taxpayer's other research expenditures must generally be apportioned to U.S. (or foreign) source income if the over-50% test is met.

d. Either method chosen by a taxpayer must remain in effect for at least five taxable years.

4. For a case applying the regulation as in effect for 1978 through 1981, see *The Perkin-Elmer Corporation v. Commissioner*, 103 T.C. 464 (1994). See also *Intel Corp. v. Commissioner,* 67 F.3d 1445 (9th Cir. 1995). With respect to the use of the same method of allocation for all purposes, see I.R.S. Field Service Advice 200207012, dated November 13, 2001.

C. Credit for Increasing Research Activities.

1. In the past, taxpayers increasing their research activities during the current year or undertaking basic research have been able to offset their tax liability by the research credit available under the tax code with respect to certain qualifying expenditures. Int. Rev. Code § 41 (formerly § 44F, and then § 30).

a. The research credit, after having been extended in 1991 to cover amounts paid or incurred through June 30, 1992, expired in 1992; was temporarily reinstated by the Omnibus Budget Reconciliation Act of 1993 to cover amounts paid or incurred through June 30, 1995; was subsequently reinstated by the Small Business Job Protection Act of

1996 to cover only amounts paid or incurred after June 30, 1996, but on or before May 31, 1997; was extended once again by the Taxpayer Relief Act of 1997 to cover expenditures paid or incurred from June 1, 1997 through June 30, 1998; and was extended by the Tax and Trade Relief Extension Act of 1998 for yet another year, to cover expenditures paid or incurred from July 1, 1998 through June 30, 1999.

b. Legislation enacted in 1999 extended the research credit again, but this time for a longer period of time. Eligible expenditures now include those paid or incurred from July 1, 1999 through June 30, 2004. For a discussion of the impact of the credit suspension periods included in the 1999 legislation, see I.R.S. Notice 2001-2, dated January 8, 2001, 2001-2 Int. Rev. Bull. 265, and I.R.S. Notice 2001-29, 2001-29 Int. Rev. Bull. 989.

c. President Bush proposed a permanent extension of the credit, which was included in the Senate amendment to the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836) but dropped in conference.

2. There are two components to the research credit. The first is an incremental credit, equal under the general rule to 20% of a taxpayer's qualified research expenditures above a base amount, which reflects that portion of the taxpayer's average gross receipts over the past four years deemed to have been spent on qualified research.

a. The Omnibus Budget Reconciliation Act of 1993 added a special provision dealing with the base amount for start-up companies (Int. Rev. Code § 41(c)(3)(B), effective in taxable years beginning after 1993), which was liberalized by the 1996 legislation.

b. In any event, however, there is a minimum base amount, and because of the minimum, the incremental credit under the general rule can equal no more than 10% of a taxpayer's qualified research expenditures for the current year.

3. There is also an elective alternative incremental credit, added by the 1996 legislation (Int. Rev. Code §41(c)(4)) and subsequently liberalized, consisting of the sum of three amounts, all based upon the amount by which a taxpayer's current qualified research expenditures exceed a defined portion of the taxpayer's average gross receipts over the prior four years (Y). See Treas. Reg. § 1.41-8, indicating that the alternative incremental credit must be elected on Form 6765, Credit for Increasing Research Activities.

a. The taxpayer must first compute three amounts – (i) 1% of Y, (ii) 1.5% of Y, and (iii) 2% of Y.

b. Then the taxpayer must determine the extent to which the taxpayer's current qualified research expenditures exceed (i) but not (ii) (Amount A), (ii) but not (iii) (Amount B), and (iii) (Amount C).

c. The alternative credit now equals 2.65% of A, 3.2% of B, and 3.75% of C; and an election to use it may be revoked in subsequent years only with the consent of the Internal Revenue Service. See I.R.S. Private Letter Ruling 200019003, dated February 2, 2000.

4. Certain basic requirements must be met before either the traditional or the alternative incremental research credit may be claimed. Proposed regulations regarding certain of these requirements were issued by the Internal Revenue Service at the end of 1998 and were published in the *Federal Register* in final form on January 3, 2001. However, the Bush Administration postponed their effective date. See I.R.S. Notice 2001-19, 2001-10 Int. Rev. Bull. 784,

indicating that any changes would be set forth in proposed regulations and that the regulations (other than the provisions dealing with internal-use software) would in no event take effect before completion of their review. New proposed regulations were published in the *Federal Register* on December 26, 2001, and, with the exception of those portions dealing with internal-use software, they were finalized in December of 2003, effective for taxable years ending on or after December 31, 2003.

a. Qualified research expenses are a prerequisite. Eligible expenditures include in-house wages attributable to research activities and supplies used in research, and 65% (or 75% in the case of payments to a qualified research consortium) of amounts paid for contract research conducted on the taxpayer's behalf in cases where the taxpayer must bear the costs even if the research efforts are unsuccessful. See Treas. Reg. § 1.41-2(e) and Int. Rev. Code §41(b)(3)(C), added by the Small Business Job Protection Act of 1996. The Internal Revenue Service has proposed a Coordinated Issue Paper addressing whether or not qualifying wages include contributions made to a 401(k) plan. See *BNA Daily Tax Report* No. 75, at L-1 (April 20, 1999). With respect to the treatment of compensation income associated with the exercise of stock options, see *Sun Microsystems v. Commissioner*, T.C. Memo 1995-69. With respect to overhead and depreciation, see I.R.S. Field Service Advice 200219001, dated September 21, 2001.

b. Qualified research must also be involved. See a proposed Coordinated Issue Paper addressing whether the redesign of a kitchen toaster involves qualified research, reprinted in *BNA Daily Tax Report* No. 145, at L-1 (July 29, 1999). Among other things, the research must be undertaken before commercial production begins for the purpose of discovering technological information, the application of

which is intended to be useful in the development of a new or improved business component, and the research cannot be conducted outside the United States, Puerto Rico or any United States possession. See Int. Rev. Code § 41(d). The standards set forth in the final but subsequently withdrawn January 3, 2001 regulations and, in particular, the requirement that the research be undertaken to obtain knowledge exceeding, expanding or refining "the common knowledge of skilled professionals in a particular field of science or engineering" were criticized. See former Treas. Reg. § 1.41-4(a)(2)-(7). The final regulations (Treas. Reg. § 1.41-4(a)(3)) drop the so-called discovery test and rely instead on the discovery principles under Section 174.

c. In addition, the research cannot be funded by another person, such as the federal government. The old regulations provide that funding for this purpose will occur (i) if the person performing the research for another retains no substantial rights in the results of the research, and (ii) to the extent a researcher who retains substantial rights in the results of the research is reimbursed for the research expenses incurred. Treas. Reg. § 1.41-5(d), applicable in taxable years beginning before 1986, redesignated as Treas. Reg. § 1.41-4A(d) in the final regulations, and made applicable currently by Treas. Reg. § 1.41-4(c)(9). See *Lockheed Martin Corp. v. United States*, 210 F. 2d 1366 (Fed. Cir. 2000), aff'g in part and rev'g in part 42 Fed. Cl. 485 (1998), dealing with expenses incurred in 1982 through 1988 by a corporation that was deemed to have retained substantial rights in the research it performed.

d. The Internal Revenue Service has treated research as having been funded where payment by the third party was expected and likely to be made. See *Fairchild Industries, Inc. v. United States*, 30 Fed.

Cl. 839 (Ct. Cl. 1994), rev'd, 71 F.3d 868 (F. Cir. 1995), where the government's position was rejected on appeal, and I.R.S. Technical Advice Memorandum 9410007, dated November 30, 1993. With respect to research funded by a member of the same controlled group (and hence not viewed as funded research), see I.R.S. Technical Advice Memorandum 8643006, dated July 23, 1986.

5. Not all expenses to which the research and experimental provisions of Section 174 apply qualify for the incremental credit. See Int. Rev. Code § 41(d)(1)(A).

a. For example, a taxpayer who has not begun trade or business operations may be unable to claim the incremental credit, but research expenditures incurred in connection with a start-up business venture are generally deductible. See Int. Rev. Code § 41(b)(1) and (4); *Snow v. Commissioner*, 416 U.S. 500 (1974); *Scoggins v. Commissioner*, 46 F.3d 950 (9th Cir. 1995). Compare, however, I.R.S. Technical Advice Memorandum 9604004, dated October 17, 1995, and *LDL Research & Development II, Ltd. v. Commissioner,* 124 F.3d 1338 (10th Cir. 1997), in which the requisite trade or business standard under Int. Rev. Code §174 was found not to have been met.

b. Similarly, product development costs may not qualify for the incremental credit but may constitute qualified research or experimental expenditures under Section 174. See H.R. Rep. No. 103-213, 103rd Cong., 1st Sess. 522 (1993); *Eustace v. Commissioner*, 312 F.2d 905 (7th Cir. 2002); I.R.S. Technical Advice Memorandum 9522001, dated December 21, 1994; Treas. Reg. § 1.41-4(b)(1).

c. The Internal Revenue Service has taken the position that wages paid to employees of an in-house patent department do not qualify for the incremental credit, even though they are eligible research or experimental expenditures under Section 174. See I.R.S. Field Service Advice 200131007, dated April 23, 2001.

d. In addition, the incremental credit is not generally available with respect to research undertaken to develop computer software (for example, accounting control software) primarily for the taxpayer's own internal use in an activity that does not constitute qualified research or a production process developed through qualified research. See Int. Rev. Code § 41(d)(4)(E); I.R.S. Notice 87-12, 1987-1 Cum. Bull. 432; the government's internal-use software audit plan published in *BNA Daily Tax Report* No. 145, at L-1 (July 29, 1996); 84 *Tax Notes* 1375 (Sept. 6, 1999), referring to an ISP Coordinated Issue Paper dealing with commercial software packages; *United Stationers, Inc. v. United States*, 982 F. Supp. 1279 (N.D. Ill. 1997), aff'd, 163 F.3d 440 (7th Cir. 1998), cert. denied, June 21, 1999; *Tax and Accounting Software Corp. v. United States*, 301 F.3d 1254 (10th Cir. 2002), rev'g and remanding 111 F. Supp. 2d 1153 (N.D. Okla. 2000), cert. denied, June 2, 2003; *Wicor, Inc. v. United States*, 116 F. Supp. 2d 1028 (E.D. Wis. 2000); and *Norwest Corp. v. Commissioner*, 110 T.C. 454 (1998). See also Revenue Procedure 97-50, 1997-2 Cum. Bull. 525, generally precluding a research credit for year 2000 costs.

e. Under proposed regulations published in the *Federal Register* on January 2, 1997, however, the incremental credit was made available with respect to internal-use software that was innovative and not commercially available for use by the taxpayer, and the development

of which involved significant economic risk. Proposed Treas. Reg. § 1.41-4(e)(5) (Jan. 2, 1997).

f. Although the regulations defining qualified research were generally finalized at the end of 2003, those portions dealing with internal-use software were not. Instead, the Treasury Department and the Internal Revenue Service issued another advance notice of proposed rulemaking, soliciting further comments on the subject. 69 Fed. Reg. 43.

g. The currently proposed regulations include the provision in the 1997 regulations noted above, as well as a provision making the credit available with respect to the cost of software developed for use in providing computer services. Proposed Treas. Reg. §1.41-4(c)(6). The exception in the regulations published in the *Federal Register* on January 3, 2001 for costs associated with making certain non-computer services available to customers has been deleted.

6. The second component of the research credit is available only to corporations that, pursuant to a written agreement, make cash grants to a qualified educational institution or scientific organization for basic research that has no specific commercial objective.

a. The credit is equal to 20% of qualifying expenditures above a floor, adjusted upwards where the corporation's non-research giving to educational institutions goes down from prior periods.

b. The basic research credit can be more advantageous than the incremental credit for organizations in existence for at least one year in the three-year period ending just before their first taxable year beginning after 1983 because, for them, the minimum basic research

amount need not equal at least 50% of the basic research payments for the current year.

c. Also, the basic research credit is generally more advantageous because the contract research payments that can be taken into account are not limited to 65% or 75%.

d. With respect to the treatment of research grants made to a tax-exempt recipient, see Int. Rev. Code § 512(b)(8), that excludes from the unrelated business taxable income of a college, university, or hospital income derived from research, not incident to commercial or industrial operations, performed for another person. See also Revenue Procedure 97-14, 1997-1 Cum. Bull. 634, discussing the circumstances under which a research agreement can result in private business use under Int. Rev. Code § 141(b) and preclude a tax-exempt organization from issuing tax-exempt bonds to fund its research facilities.

7. Both components of the research credit will reduce a taxpayer's deduction for research and experimental expenditures unless the taxpayer irrevocably elects to reduce the credit by the taxes deemed saved by not offsetting an amount equal to the credit against the otherwise allowable deductions. Int. Rev. Code § 280C(c).

8. With respect to the research credit, see generally the Internal Revenue Service's *MSSP Audit Technique Guide for Computers, Electronics, High Tech Industry*, published in *BNA Daily Tax Report* No. 167, at L-1 (Aug. 28, 1998), discussing the tax treatment of research and development costs. With respect to the government's research credit recordkeeping agreement (RCRA) pilot program, see I.R.S. Notice 2003-11, 2004-6 Int. Rev. Bull. 434. See also the proposed amendments to Treas. Reg. § 1.41-8

(redesignated as § 1.41-6 by the December 26, 2001 proposed regulations and entirely reproposed in July of 2003), dealing with the computation of the research credit available to members of a controlled group of corporations.

9. For the credit available for expenses incurred before 1995 and after June 30, 1996 in the clinical testing of drugs intended to combat rare diseases, see Int. Rev. Code §45C (formerly § 28). A permanent extension of this credit was included in the Taxpayer Relief Act of 1997.

D. Copyright Expenditures.

1. The costs that a taxpayer incurs to copyright material produced by or on behalf of the taxpayer are generally capital in nature and hence are not currently deductible. Treas. Reg. § 1.263(a)-2(b); cf. Treas. Reg. § 1.263(a)-4(d)(1), dealing with certain other created intangibles. Also, Section 197, dealing with the amortization of intangibles, does not apply to the costs associated with a self-created (in the traditional sense) copyright. See Int. Rev. Code § 197(c)(2) and (e)(4)(C).

2. However, if the copyright is used in the taxpayer's trade or business or income-producing activity, and these costs are neither deducted as research and experimental expenditures under Section 174 nor subject to the uniform capitalization provisions of Section 263A, it appears that they can be depreciated over the useful life of the copyright. See Int. Rev. Code § 167(f)(2), which applies to copyrights, and I.R.S. Technical Advice Memorandum 9326043, dated April 2, 1993.

a. The regulations under Int. Rev. Code § 167(f)(2) (Treas. Reg. § 1.167(a)-14(c)(4)) support the availability of depreciation under the circumstances. Cf. I.R.S. Private Letter Ruling 9549023, dated September 8, 1995, in which the Internal Revenue Service declined to

rule on the availability of a depreciation deduction, noting an open regulations project on the amortization of copyrights.

b. The regulations expressly recognize the straight-line method of depreciation over a copyright's remaining useful life, as well as the income forecast method, consistent with the fact that Section 167(g)(6), added by the Taxpayer Relief Act of 1997, expressly permits the use of the income forecast method with respect to copyrights (as well as patents and other property specified by regulation). See Treas. Reg. § 1.167(a)-6(a); Treas. Reg. § 1.167(a)-14(c)(4); Revenue Ruling 89-62, 1989-1 Cum. Bull. 78; I.R.S. Technical Advice Memorandum 8501006, dated September 24, 1984). The computation of depreciation under the income forecast method is discussed in Proposed Treas. Reg. §§ 1.167(n)-1 through 1.167(n)-7.

c. Nevertheless, the effect of the Copyright Act of 1976 has been to extend the depreciation period beyond one that is useful for tax purposes where the taxpayer is unable to establish a shorter useful life. See Revenue Ruling 73-395, 1973-2 Cum. Bull. 86. Prior to 1998, the copyright of a work created after 1977 extended for the life of the author plus 50 years, or, in the case of a work for hire, for 75 years from the year of first publication or, if sooner, 100 years from the year of creation. The Sony Bono Copyright Term Extension Act, enacted in 1998, replaced 50, 75 and 100 years with 70, 95 and 120 years, respectively. See *Eldred v. Ashcroft*, 123 S. Ct. 769 (2003), in which the Supreme Court upheld the constitutionality of this legislation.

d. Query whether Proposed Treas. Reg. § 1,167(a)-3(b)(1) will permit amortization over a deemed useful life of 15 years.

3. The regulations provide that if a copyright becomes worthless in a year before it expires, the taxpayer can deduct the unrecovered costs in that year. Treas. Reg. § 1.167(a)-6(a); Treas. Reg. § 1.167(a)-14(c)(4). If the copyright is abandoned, the taxpayer may also be able to write off the unrecovered costs when the abandonment occurs. See Revenue Ruling 73-395, *supra*; Int. Rev. Code § 1234A, as amended by the Taxpayer Relief Act of 1997.

4. Note also that the so-called uniform capitalization provisions now generally apply to amounts spent to secure and produce a copyright for a film, sound recording, videotape, book, or the like, and when these rules apply, a taxpayer will be required to add these amounts to the cost of producing the film or such other property. See Int. Rev. Code § 263A(b) and (h); Treas. Reg. § 1.263A-2(a)(2)(ii).

E. Trademark Expenditures.

1. Capital expenditures connected with the development and registration of a trademark are treated differently from research and experimental expenditures.

a. Capitalization is required under general principles of tax law.

b. Note that Treas. Reg. § 1.263(a)-4(d)(1), regarding the requirement to capitalize amounts paid to create certain intangibles, does not appear to require capitalization, although it is clear from Treas. Reg. § 1.263(a)-4(f)(3) that some Section 197 intangibles are impacted by the regulation.

2. Since 1986, it has not been possible to amortize trademark expenditures over a period of 60 months or more. Section 177 (that dealt with any capital expenditure directly connected with the acquisition, protection, expansion, registration, or defense of a trademark not acquired by purchase, either separately or as part of a business) was repealed by the Tax Reform Act of 1986.

3. The repeal of Section 177 left the tax code provision (Section 167(r)) stating that trademark expenditures (apparently however acquired) were not depreciable, which itself was repealed by the Revenue Reconciliation Act of 1989.

4. Thus, after the 1989 legislation, trademark expenditures with a limited useful life became depreciable. Presumably, Congress felt that this change in the law would not provide a significant tax benefit because that portion of the House Report dealing with the repeal of Section 167(r) states that "[i]t is expected that no deduction will be allowed . . . for any amount that is payment for an asset with an indeterminate useful life." H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1350 (1989).

5. The Omnibus Budget Reconciliation Act of 1993 has changed the rules once again. A taxpayer who develops a trademark held in connection with the conduct of a trade or business or an income-producing activity will now be able to amortize his or its trademark expenditures over a period of 15 years. See Int. Rev. Code § 197(c)(2) and (d)(1)(F); Treas. Reg. § 1.197-2(d)(2)(iii)(A).

III. **Licensing Property from a Third Party**.

A. Instead of developing intellectual property, a taxpayer may decide to license intellectual property rights from a third party in exchange for royalties payable periodically.

1. In theory, it would seem, royalty payments should be treated just like rent – i.e., they should be deductible currently as an ordinary and necessary business expense, when paid or accrued.

2. The actual tax consequences of a royalty arrangement, however, will depend upon the nature of the intellectual property involved and upon whether or not a sale is deemed to have occurred, a subject that is discussed later in this outline. See also Revenue Ruling 81-178, 1981-2 Cum. Bull 135, distinguishing royalties from compensation for services rendered, and *Speer v. Commissioner*, T.C. Memo 1996-323, in which the government sought to characterize license payments as a constructive dividend.

3. Note that even if there is also an up-front, lump sum payment, the transaction can be characterized as a license rather than a sale for tax purposes.

B. If a taxpayer takes a non-exclusive license under a patent or secures a non-exclusive license to use a copyright or know-how, the taxpayer will not be deemed to have purchased an asset. However, the ability of the taxpayer to deduct any annual royalty payments currently as an ordinary and necessary business expense is impacted by Section 197 and the regulations recently finalized thereunder (discussed below).

1. Although the House Report on the Omnibus Budget Reconciliation Act of 1993 (H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 761) indicates that Section 197 was generally not intended to apply to amounts that were not required to be capitalized under prior law, as a general rule, Section 197

applies to any right to use an intangible that, if acquired outright, would have been covered by Section 197. See Treas. Reg. § 1.197-2(b)(11).

2. Unless an exception applies, a taxpayer who licenses certain intellectual property will be unable to deduct the license fees on essentially a pay-as-you go basis. There are three exceptions in the final regulations, one developed pursuant to Section 197(e)(4)(D).

   a. In general, the first exception covers licenses of know-how (or certain other intangibles) entered into in the ordinary course of business and not as part of the acquisition of a trade or business. Typically these licenses cannot exceed 15 years in duration. Treas. Reg. § 1.197-2(c)(13).

   b. A second exception covers a license relating to a patent, copyright, know-how, or similar property, so long as the license fees are arm's-length in amount and the license does not involve a transfer of all, or an undivided interest in all, substantial rights to the underlying property. Treas. Reg. § 1.197-2(f)(3)(ii).

   c. A final exception covers licenses unconnected with the purchase of a trade or business, so long as the license itself is not deemed to involve a sale or exchange. Treas. Reg. § 1.197-2(f)(3)(iii). See I.R.S. Private Letter Ruling 200137013, dated June 8, 2001.

3. As a result of these exceptions, all fees paid by a taxpayer who takes a non-exclusive license under a patent or secures a non-exclusive license to use a copyright or know-how should continue to be deductible on an essentially pay-as-you go basis. The actual timing of a deduction may depend upon the taxpayer's method of accounting. See Treas. Reg. § 1.167(a)-14(c)(2) and Treas. Reg. § 1.197-2(a)(3).

4. However, if the consideration due consists in whole or in part of an up-front lump-sum payment, the taxpayer will presumably be required to amortize the payment ratably over the term of the license. See I.R.S. Field Service Advice 199941018, dated July 12, 1999, dealing with the amortization of the value of stock warrants granted to a licensor of technology.

5. Also, under appropriate circumstances, the taxpayer may be required to add each annual royalty payment to the cost of the asset, in the production of which the patent, copyright, or know-how is used. See Treas. Reg. § 1.263A-1(e)(3)(ii)(U) and the discussion below relating to trademarks. With respect to the capitalization of patent royalty payments and their inclusion in ending inventory, see *Plastic Engineering & Technical Services, Inc.*, T.C. Memo 2001-324.

C. A taxpayer who licenses computer software on a non-exclusive basis for use in a trade or business must today also focus upon the impact of Section 197.

1. In the past, a taxpayer who licensed computer software on a non-exclusive basis for use in a trade or business was able to deduct the lease payments currently under Treas. Reg. § 1.162-11, dealing with rental payments. See Revenue Procedure 69-21, *supra*.

2. The regulations under Section 167 recognize this provision (Treas. Reg. § 1.167(a)-14(b)(2)), so that a taxpayer who licenses computer software on a non-exclusive basis for use in a trade or business or an income-producing activity will typically be treated just like a business lessee for tax purposes if the consideration is payable in the form of an annual royalty, provided that the computer software, if purchased outright, would not have been amortizable only under Section 197 (see the discussion below). This approach is reflected in Revenue Procedure 2000-50, *supra*.

3. On the other hand, if the consideration under the same circumstances consists of a single up-front lump-sum payment, the regulations could be read to require the taxpayer to amortize the payment ratably a period of 36 months, unless expensing is available under Section 179. See Treas. Reg. § 1.167(a)-14(b)(1).

   a. Cf. Treas. Reg. § 1.263(a)-4(c)(2), stating that amounts paid for a non-exclusive license of readily available software will be deemed to have been paid to purchase the property.

   b. See also I.R.S. Publication 946 (How to Depreciate Property, for use in preparing 2003 returns), at page 15, indicating that the cost of off-the-shelf computer software is now eligible for expensing under Section 179. This reflects the provisions of Section 179(d)(1)(A)(ii), relating to computer software placed in service in a taxable year beginning after 2002 and before 2006.

D. If the license relates to a trademark, a relatively complex set of rules in the tax code will apply instead. Significant changes were made in these rules in 1989. Int. Rev. Code § 1253, as amended by the Revenue Reconciliation Act of 1989.

1. A taxpayer who enters into a license to use a trademark that is not treated as a sale for tax purposes (see Int. Rev. Code § 1253(a) and (b)(2), discussed later in this outline) will be able to deduct his or its royalty payments currently as an ordinary and necessary business expense if the royalty payments made under the trademark license:

   a. Are contingent on the productivity, use, or disposition of the trademark;

   b. Are payable at least annually throughout the term of the transfer agreement; and

c. Are substantially equal in amount or payable under a fixed formula.

Int. Rev. Code § 1253(d)(1), as amended by the Revenue Reconciliation Act of 1989.

2. Prior to the Omnibus Budget Reconciliation Act of 1993, different rules applied to all other non-exclusive licenses. Lump sum payments of up to $100,000 were amortizable over no more than 10 years; a series of substantially equal payments made in discharge of a lump sum totaling no more than $100,000, if payable over more than 10 years or the term of the license agreement, were deductible when paid; certain other amounts were amortizable at the taxpayer's election over a period of 25 years; and otherwise, the taxpayer was required to capitalize the royalty payments and was able to depreciate them over the useful life of the acquired property if a limited life was ascertainable. Int. Rev. Code § 1253(d)(2) and (3), as in effect after the Revenue Reconciliation Act of 1989 and before the Omnibus Budget Reconciliation Act of 1993. For a case decided under the law as in effect in 1982 and 1983, see *Nabisco Brands, Inc. v. Commissioner*, T.C. Memo 1995-127.

3. The 1993 budget legislation greatly simplified the provisions of Section 1253. All payments, other than those to which the provisions of Section 1253(d)(1) apply, must now be capitalized (Int. Rev. Code § 1253(d)(2) as now in effect), and the capitalized amount can be amortized over a period of 15 years. See Int. Rev. Code § 197(c)(2), (d)(1)(F), and (f)(4)(C); Treas. Reg. § 197-2(b)(10).

a. This provision applies, for example, to the cost of renewing a license to use a trademark. See Int. Rev. Code § 197(f)(4)(B).

b. Although the statute states that, to the extent provided by regulation, Section 197 will not apply to any right acquired, other than in connection with the acquisition of a trade or business, under a contract that has a fixed duration of less than 15 years (Int. Rev. Code § 197(e)(4)(D)), the final regulations do not extend this exception to a trademark license that extends for less than 15 years. Treas. Reg. § 1.197-2(c)(13)(i)(B).

4. Note, however, that, in general, under the uniform capitalization provisions of Section 263A, a taxpayer who produces tangible personal property or a taxpayer with significant gross receipts who acquires property for resale must capitalize (as part of the cost of the property) all direct and indirect costs associated with the production or acquisition of the property. Int. Rev. Code § 263A(a) and (b)(2). Indirect costs include the fees incurred to secure the right to use a trademark associated with property produced or acquired for resale. Treas. Reg. § 1.263A-1(e)(3)(ii)(U). Presumably, any such fee will, to the extent currently deductible under Section 1253(d)(1) or 197, be subject to the provisions of Section 263A.

E. Like a taxpayer with foreign source income who incurs research and experimental expenditures, a non-exclusive licensee with both foreign and domestic operations must determine the source of the licensee's royalty payments, in order to determine the foreign tax credit available to offset his or its U.S. tax liability (see the discussion above).

1. Here, there are no special rules. Instead, the licensee must seek guidance under the general tax code provision pursuant to which, in general, expenses and deductions must be apportioned first to the items of gross income to which they relate, and then, to the extent a definite allocation cannot be made, ratably among all items of gross income. Expenses and deductions

allocated to gross income deemed to be sourced abroad will reduce foreign source income, and, conversely, expenses and deductions allocated to gross income deemed to be sourced in the United States will reduce U.S. source income. Int. Rev. Code §§ 861(b), 862(b), and 863(a) and (b).

2. For certain rules allocating deductions, see Treas. Reg. § 1.861-8 and Temporary Treas. Reg. § 1.861-8T.

3. For provisions to be applied when determining the source of the deductions claimed by any member of an affiliated group, see Int. Rev. Code § 864(e).

F. A non-exclusive licensee who is not deemed to have purchased intellectual property and who makes royalty payments to a non-resident alien individual, a foreign corporation, or a foreign partnership must determine whether U.S. taxes are required to be withheld from each payment.

1. If the payments constitute a royalty for the use of, or the privilege of using, a patent, copyright (see Revenue Ruling 72-232, 1972-1 Cum. Bull. 276), secret process and formula, or trademark in the United States (see Int. Rev. Code §§ 861(a)(4), 871(a)(1)(A), and 881(a)(1)), withholding at the statutory rate of 30% or at the lower treaty rate will be required (see Int. Rev. Code §§ 1441 and 1442; *SDI Netherlands B.V. v. Commissioner*, 107 T.C. 161 (1996)) unless the payments are effectively connected with the licensor's conduct of a trade or business in the United States and are thereby includable in the recipient's U.S. tax base under Section 871(b) or 882(a) (see Int. Rev. Code § 864(c)(2)). With respect to licenses of computer software, see I.R.S. Field Service Advice 200222011, dated February 26, 2001, and a discussion of the position taken by Mexico in *BNA Daily Tax Report* No. 126, at G-5 (July 1, 2003).

a. Note that under most treaties to which the United States is a party, royalties will be taxed at less than 30% unless the limitation-on-benefits article precludes use of the lower rate (see I.R.S. Publication 901, U.S. Tax Treaties). See, e.g., Article 12 of the U.S.-Japan Convention for Avoidance of Double Taxation, signed November 6, 2003.

b. Note also that for withholding tax purposes, the right to use know-how has been described as being not materially different from the right to use a trademark or secret process and formula. Revenue Ruling 55-17, 1955-1 Cum. Bull. 388.

c. For a general discussion of the withholding requirements, see the preambles to the final regulations under Int. Rev. Code §§ 1441 and 1442 published in the *Federal Register* on October 14, 1997 and the amendments thereto published in the *Federal Register* on May 22, 2000. The regulations took effect on January 1, 2001, as set forth in T.D. 8856, 2000-3 Int. Rev. Bull. 297.

2. If the payments constitute a royalty for the use of, or the privilege of using, a patent, copyright, secret process and formula, or trademark outside the United States (see Int. Rev. Code § 862(a)(4)), withholding will not be required, although the recipient may be taxed on the payments in the United States if he or it maintains a fixed place of business within the United States. See Int. Rev. Code § 864(c)(4)(B)(i).

3. Also, to the extent any payments are found to represent compensation for services rendered, no withholding will be required if the services were performed outside of the United States. Revenue Ruling 55-17, *supra*. See *Miller v. Commissioner,* T.C. Memo 1997-134.

a. With respect to the source of compensation income generally, see Int. Rev. Code § 861(a)(3). See also Int. Rev. Code § 7701(b), defining the term "nonresident alien."

b. Note that treaties typically include special rules discussing the extent to which a treaty partner may tax compensation earned within its jurisdiction. See, for example, Article XV of the U.S.-Canada income tax treaty.

4. Note finally that some have argued that shrink-wrapped computer software licensed to retail consumers who have no right to reproduce the software should not be deemed to have been licensed for purposes of the withholding tax provisions. See 91 *Tax Notes Today* 237-51 (Nov. 20, 1991); 92 *Tax Notes Today* 199-75 (Oct. 1, 1992).

a. With the adoption of the 1995 protocol amending the U.S.-Canada income tax treaty, however, the problem sought to be eliminated by this approach has been dealt with in a different way.

b. See also the preamble to Proposed Treas. Reg. § 1.861-18, published in the *Federal Register* on November 13, 1996, stating that the transfer of a computer program on a disk subject to a shrink-wrap license constitutes the sale of a copyrighted article, not the transfer of a copyright right. Compare as well (i) the approach taken in the temporary regulations promulgated under the foreign sales corporation ("FSC") provisions (Temporary Treas. Reg. § 1.927(a)-1T(f)(3)), with (ii) the change in Int. Rev. Code § 927(a)(2)(B) made by the Taxpayer Relief Act of 1997, extending the benefit of the FSC provisions to exporters of master copies of computer software. Cf. I.R.S. Private Letter Ruling 9633005, dated August 16, 1996.

G. With respect to the treatment of an amount equal to three times the annual royalties paid by a controlled foreign corporation for the use of intangible property as an asset of the corporation for purposes of determining whether the passive foreign investment company (PFIC) provisions of the tax code apply to its U.S. shareholders, see Int. Rev. Code § 1298(e)(2), added by the Omnibus Budget Reconciliation Act of 1993, as well as the discussion of this provision later in this outline.

H. As to the excludability of royalties from the unrelated business taxable income of a tax-exempt organization, see Int. Rev. Code § 512(b)(2); Revenue Ruling 76-297, 1976-2 Cum. Bull. 178; and Revenue Ruling 81-178, *supra*. See also I.R.S. Private Letter Ruling 9717021, dated January 22, 1997, and I.R.S. Private Letter Ruling 9816027, dated January 20, 1998.

1. In a recent private letter ruling, the Internal Revenue Service declined to treat royalties paid to a scientific research organization as unrelated trade or business income and concluded that the research conducted at the organization's facility did not constitute an unrelated trade or business. I.R.S. Private Letter Ruling 200326035, dated April 4, 2003.

2. Compare, however, Revenue Ruling 73-193, 1973-1 Cum. Bull. 262, where a tax-exempt organization was deemed to have received taxable compensation for patent development and management services.

IV. Securing an Assignment of Intellectual Property from a Third Party.

A. If, instead of licensing intellectual property rights on a non-exclusive basis, a taxpayer takes an assignment of the property or enters into an exclusive license to use the property, different rules will determine the deductibility of the consideration paid if a sale is deemed to have occurred for tax purposes and the transaction does not involve a tax-free like-kind exchange of intellectual property to which the

provisions of Section 1031 apply (see the discussion of Section 1031 later in this outline).

1. In general, a taxpayer will be deemed to have purchased intellectual property (i.e., there will have been a sale for tax purposes) if the transfer includes all substantial rights to the property, including the right to use it for its full remaining life and the right to prevent its unauthorized disclosure. See *E.I. duPont de Nemours & Co. v. United States*, 288 F.2d 904 (Ct. Cl. 1961); Revenue Ruling 55-540, 1955-2 Cum. Bull. 39; Revenue Ruling 60-226, 1960-1 Cum. Bull. 26; Revenue Ruling 2003-28, 2003-11 Int. Rev. Bull. 594 (dealing with the contribution of a patent to a university). See also Treas. Reg. Sec. 1.861-18(f)(1), indicating that the transfer of a copyright right in a computer program will constitute a sale for the purposes set forth in the regulation if all substantial rights in the right are transferred.

   a. The extent to which rights must be transferred in order to insure a sale, however, remains unclear, given the apparent differences in approach taken in court decisions rendered before and after enactment of the 1954 tax code. Cf. I.R.S. National Office Legal Advice 200234039, dated May 17, 2002.

   b. It seems reasonably clear that, under any analysis, a sale will not occur if the transferee agrees to allow the transferor to exploit the property in the same territory (see Revenue Ruling 69-156, 1969-1 Cum. Bull. 101) or if the transferee itself cannot use the property, at least where the right to use is a substantial one (see *Waterman v. Mackenzie*, 138 U.S. 252 (1891), involving a transfer of the right to "make, use, and vend"). See also *Broadcast Music, Inc. v. Hirsch*, 104 F.3d 1163 (9th Cir. 1997), discussing whether a transfer of copyright ownership had occurred.

c. On the other hand, the pre-1954 precedents indicating that a sale can occur even if the rights transferred extend only to a particular territory, or industry, may remain in effect. See *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955).

2. Normally, an exclusive license to make, use, and sell property will be treated as a sale for tax purposes (see *Myers v. Commissioner*, 6 T.C. 258 (1946)), even if the licensor retains certain protections such as the right to terminate the agreement if the licensee does not meet certain performance standards (see *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955); *Newton Insert Co. v. Commissioner*, 61 T.C. 570 (1974)), so long as the exclusive right remains in effect for the full remaining life of the property to which it relates (see Revenue Ruling 84-78, 1984-1 Cum. Bull. 173). But see an article in *Forbes* (Oct. 24, 1994, at 92) that suggests that the Justice Department might preclude a patent holder from licensing a patented product on an exclusive basis if the license has the effect of reducing competition in violation of the U.S. anti-trust laws.

a. Note, however, that certain special provisions in the tax code may determine whether or not a sale has occurred for tax purposes or may indirectly influence the analysis. These are discussed later in this outline.

b. Note also that Treas. Reg. § 1.861-18(f) indicates that the sale of a copyrighted computer program, as distinguished from the sale of a copyright right, will be deemed to have occurred for tax purposes only if sufficient benefits and burdens of ownership are transferred.

B. The regulations now explicitly provide that a taxpayer must capitalize the cost of purchased intangibles, including patents, copyrights, computer software, trademarks, and trade names, unless the cost is includible in the recipient's income as

compensation for services rendered. Treas. Reg. §§ 1.263(a)-4(c)(1)(vii), (viii) and (xiv) and 1.263(a)-4(c)(3).

1. Generally, a taxpayer who acquires tangible property in a sale transaction can deduct the purchase price over a period of years under the current version of the ACRS system that was introduced in 1981, and that has since been modified. Int. Rev. Code § 168.

2. Intangibles, however, are treated differently.

C. The Omnibus Budget Reconciliation Act of 1993 added to the tax code a provision (Int. Rev. Code § 197) that deals specifically with the amortization of intangibles acquired (other than in certain anti-churning transactions) after August 10, 1993, when the provision was enacted (or, on an elective basis, after July 25, 1991), and held in connection with the conduct of a trade or business or an income-producing activity. See Temporary Treas. Reg. § 1.197-1T; I.R.S. Notice 94-90, 1994-2 Cum. Bull. 561

1. The entire adjusted basis of an intangible to which Section 197 of the tax code applies (excluding from basis any amounts that represent either compensation for services rendered or imputed interest) can be deducted ratably over a period of 15 years, beginning with the month of acquisition. The final regulations published in the *Federal Register* on January 25, 2000 discuss the mechanics of amortization, including the date on which amortization begins and the treatment of contingent payments. See Treas. Reg. § 1.197-2(f).

2. Patents and copyrights used in a trade or business or an income-producing activity and acquired in connection with the acquisition of assets constituting a trade or business or a substantial portion of a trade or business are covered

under Section 197. See Int. Rev. Code § 197(d)(1)(C)(iii) and (e)(4)(C); Treas. Reg. § 1.197-2(b)(5) and (c)(7).

3. Any purchased "formula, process, design, pattern, know-how, format, or other similar item" is also covered if it was not produced for the taxpayer under a contract entered into before the intangible was produced (i.e., if it is not a self-created intangible) or, if it was, it was created in connection with the acquisition of assets constituting a trade or business or a substantial portion of a trade or business. See Int. Rev. Code § 197(c)(2) and (d)(1)(C)(iii); Treas. Reg. § 1.197-2(b)(5) and (d)(2)(iii)(B).

4. Computer software (that is, in general, any program designed to cause a computer to perform a desired function) is covered (see Int. Rev. Code § 197(e)(3) and Treas. Reg. § 1.197-2(c)(4)) if:

   a. It is customized (that is, it is not readily available for purchase by the general public or it is subject to an exclusive license or it has been substantially modified); and, in addition,

   b. It is deemed to have been purchased in connection with the acquisition of assets constituting a trade or business or a substantial portion of a trade or business (note that the House Report on the Omnibus Budget Reconciliation Act of 1993 (H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 766 (1993) and Treas. Reg. § 1.197-2(e)(2)(i) provide that the acquisition of a trademark or a trade name constitutes the acquisition of a trade or business or a substantial portion thereof, although Treas. Reg. § 1.197-2(e)(2)(ii) adopts certain exceptions to this general rule); and based on the legislative history,

   c. The capital cost of the software is not required to be taken into account as part of the cost of computer hardware or other tangible

property (see H.R. Rep. No. 103-213, 103rd Cong., 1st Sess. 680 (1993)).

5. All trademarks are covered unless the current law provision dealing with the deductibility of contingent payments (Int. Rev. Code § 1253(d)(1)) applies. See Int. Rev. Code § 197(d)(1)(F) and (f)(4)(C); Treas. Reg. § 1.197-2(b)(10). Note, also, that the cost of renewing a trademark must be amortized over 15 years, beginning with the month of renewal. See Treas. Reg. § 1.197-2(f)(4)(i).

D. Patents to which the provisions of Section 197 do not apply (because they are not acquired in connection with the acquisition of all or a substantial portion of a trade or business) remain depreciable under Section 167, as amended by the Omnibus Budget Reconciliation Act of 1993. See Int. Rev. Code §§ 167(f)(2) and 197(e)(4)(C); I.R.S. Private Letter Ruling 200416002, dated December 19, 2003.

1. In 1945, the Tax Court concluded that, where the acquisition price of a patent consists of periodic payments contingent on use, the actual payments made may be deducted as depreciation. *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

   a. This principle (the variable contingent payment method of depreciation) holds true today. See *Newton Insert Co. v. Commissioner*, *supra*, and Revenue Ruling 67-136, 1967-1 Cum. Bull. 58. Note that the ruling relates to amounts paid to acquire both patents and patent applications relating to inventions on which a patent would be issued in the normal course.

   b. The House Report on Section 197 in effect directed the Treasury Department to issue regulations providing that "if the purchase price of a patent is payable on an annual basis as a fixed percentage of the

revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent equals the amount of the royalty paid or incurred during such year." See H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 769 (1993).

c. The language in the House Report has been reflected in the final regulations under Section 167(f)(2).

2. If the *Associated Patentees* principle does not apply, the purchase price of a patent can be deducted over its remaining useful life under the final regulations recently promulgated under Section 167 (as under the old regulations). Treas. Reg. § 1.167(a)-6(a); Treas. Reg. § 1.167(a)-14(c)(4). Thus, when a fixed, lump sum price is paid for a patent, it will normally be amortizable ratably over the remainder of the statutory life of the patent.

a. In the case of a design patent, the statutory life is 14 years from date of issue.

b. In the case of a utility patent, the statutory life is 17 years from date of issue for patents filed before June 8, 1995 and 20 years from date of filing for patents filed on or after June 8, 1995.

c. The safe harbor 15-year amortization provision of Proposed Treas. Reg. § 1.167(a)-3(b)(1) will presumably not impact purchased patents.

3. In the past, it was recognized that special circumstances might call for a different treatment of the purchase price paid for a patent.

a. The price paid for patents acquired as a group was under appropriate circumstances found to be deductible ratably over the remaining

useful life of the most significant patent or the average remaining life of the acquired patents, or based upon the percentage of days of expiring life in a particular year to the total annual days of unexpired life for the entire group. See *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3rd Cir. 1937); *Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954); *Simmonds Precision Products, Inc. v. Commissioner*, 75 T.C. 103 (1980).

b. Also, under appropriate circumstances, the income forecast method rather than the straight-line method of depreciation was stated to be available. Revenue Ruling 79-285, 1979-2 Cum. Bull. 91. For a discussion of this method, see I.R.S. Technical Advice Memorandum 9603004, dated October 4, 1995.

c. The regulations initially proposed under Section 197 appeared to recognize only straight-line depreciation. See *Spencer v. Commissioner*, 110 T.C. 62 (1998), dealing with the amortization of contract rights under Section 167. However, Section 167(g)(6), added by the Taxpayer Relief Act of 1997, makes the income forecast method available with respect to patents (as well as copyrights and other property specified by regulation), and this provision is reflected in the final regulations. See also Proposed Treas. Reg. §§ 1.167(n)-1 through 1.167(n)-7, discussing the income forecast method.

4. If a patent becomes worthless in a year before it expires, the taxpayer can deduct his or its unrecovered costs in that year. Treas. Reg. § 1.167(a)-6(a); Treas. Reg. § 1.167(a)-14(c)(4).

a. The new limitations under Section 197 on the ability of a taxpayer to claim a worthless loss deduction do not apply to depreciable patents. See Int. Rev. Code § 197(f)(1)(A).

b. Also, if the taxpayer abandons the patent instead, presumably an abandonment loss will become available at that time. See Revenue Ruling 73-395, *supra*; Int. Rev. Code § 1234A as amended by the Taxpayer Relief Act of 1997.

E. The price that a taxpayer pays to purchase a copyright to which the provisions of Section 197 do not apply (because the copyright is not acquired in connection with the acquisition of all or a substantial portion of a trade or business) will be treated in the same way as the capitalized costs that a taxpayer incurs to copyright material produced by or on behalf of the taxpayer.

1. Thus, the price can be depreciated over the remaining useful life of the copyright. See Int. Rev. Code §§ 167(f)(2) and 197(e)(4)(C); Treas. Reg. § 1.167(a)-14(c)(4). See also, however, Treas. Reg. § 1.263(a)-2(b), that refers to the uniform capitalization provisions mentioned above. Note that the 15-year safe harbor amortization provisions of Proposed Treas. Reg. § 1.167(a)-3(b) will presumably not apply to purchased copyrights.

2. There may, however, be additional relevant factors.

a. If the purchase price consists of periodic payments contingent on use, the actual payments will be deductible as depreciation under the variable contingent payment method of depreciation. See Revenue Ruling 60-226, *supra,* and Treas. Reg. § 1.167(a)-14(c)(4), specifically endorsing this method of depreciation.

b. Moreover, it may be necessary to divide the purchase price between the copyright, itself, and any tangible property in which the copyright resides, since different tax law principles govern the deductibility of the cost of tangible property. See, in this regard, Treas. Reg. § 1.861-18 that, although not directly relevant, describes four

copyright rights: the right to make copies for distribution to the public, the right to prepare derivative works, the right to perform publicly, and the right to display publicly. See also I.R.S. Field Service Advice 200019021, dated May 12, 2000, distinguishing copyrights from film characters viewed as trademark rights.

F. The provisions of Section 197 in effect permit a purchaser of know-how (that is, any formula, process, design, pattern, know-how, format, or other similar item) to amortize the purchase price over a period of 15 years, whether the know-how is acquired separately or in connection with the acquisition of a trade or business (only know-how self-created other than in connection with the acquisition of a trade or business is treated differently).

1. However, as noted above, the statute (Int. Rev. Code § 197(e)(4)(D)) gives the government the authority to promulgate regulations excluding from the term "section 197 intangible" any contract right extending over a period of less than 15 years that was not acquired in connection with the acquisition of a trade or business. By reason of this provision, a taxpayer may be able to amortize the cost of some purchased know-how over a period of less than 15 years. See H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 771 (1993); Int. Rev. Code § 167(f)(2); Treas. Reg. §§ 1.197-2(c)(13) and 1.167(a)-14(c)(2).

2. Under prior law, know-how was generally not depreciable because the regulations provide that an asset with an unlimited useful life cannot be depreciated. Treas. Reg. § 1.167(a)-3.

   a. Trade secrets, for example, were found to have an indefinite useful life — until they became public knowledge, at which point they were no longer subject to protection under applicable law. See Revenue Ruling 71-564, 1971-2 Cum. Bull. 179.

b. In an unusual 1983 victory for the taxpayer, however, the Court of Claims permitted a corporation to depreciate the price that it paid for a secret formula that was determined under the circumstances to have a limited useful life. *Liquid Paper Corp. v. United States*, 2 Fed. Cl. 284 (Ct. Cl. 1983).

3. Under current law, it may still be necessary to determine whether the price paid for property includes the cost of separately identifiable know-how, where the property to which the know-how relates is depreciable over a period other than 15 years.

a. In an analogous situation, the Internal Revenue Service, upon the audit of a company that acquired satellite transponders, sought at the District level to allocate some portion of the purchase price to two intangible assets, characterized by the District as neighborhood effect and protected status, in an effort to reduce the amount eligible for an investment tax credit. See I.R.S. Technical Advice Memorandum 9317001, dated January 12, 1993.

b. Note also, in this regard, Treas. Reg. § 1.861-18 that expressly recognizes the distinction between know-how and a copyrighted article.

G. The cost of purchased computer software, used in a trade or business or an income-producing activity, to which the provisions of Section 197 do not apply is now depreciable on a straight-line basis over a period of 36 months. Int. Rev. Code § 167(f)(1). See Revenue Procedure 2000-50, *supra* and Treas. Reg. § 1.263(a)-4(c)(2).

1. This approach replaces the approach taken by the Internal Revenue Service in Revenue Procedure 69-21, *supra*, pursuant to which a taxpayer could

amortize the separately stated cost of computer software ratably over a period of five years or, if less, the useful life of the software in the hands of the taxpayer. See, however, *Sprint Corp. v. Commissioner*, 108 T.C. 384 (1997), in which software loads acquired with digital switches were found to be depreciable as tangible personal property.

2. The amortization period begins with the month in which the computer software is placed in service. Treas. Reg. § 1.167(a)-14(b)(1). With respect to the amortization of purchased enterprise resource planning software, see I.R.S. Private Letter Ruling 200236028, dated June 4, 2002.

3. However, according to the House Report on the Omnibus Budget Reconciliation Act of 1993 and the regulations, a taxpayer who acquires computer hardware and computer software for a single stated price must continue to treat the total purchase price as a payment for depreciable hardware. See H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 767 (1993); Treas. Reg. § 1.167(a)-14(b)(2).

4. See also *Norwest Corp. v. Commissioner*, 108 T.C. 358 (1997), in which the Tax Court characterized certain computer software as tangible personal property eligible for the investment tax credit.

H. The Omnibus Budget Reconciliation Act of 1993 has changed the tax treatment of the price paid for a trademark, but, as under prior law, trademarks continue to be treated differently from patents, copyrights, and know-how.

1. If the price paid for a trademark is contingent on the productivity, use, or disposition of the trademark and is payable throughout the term of the transfer agreement in at least annual installments that are either substantially equal in amount or payable under a fixed formula, the purchaser (just as a non-exclusive licensee under the same circumstances) will be able to deduct

each installment payment as an ordinary and necessary business expense. Int. Rev. Code § 1253(d)(1), as amended by the Revenue Reconciliation Act of 1989. See, however, Treas. Reg. § 1.263A-1(e)(3)(ii)(U).

2. Under the provisions of Section 197, the purchase price will, in all other cases (whether or not the trademark is acquired separately), be amortizable ratably over a period of 15 years, shorter than the elective 25-year period available in some circumstances under prior law (former Int. Rev. Code § 1253(d)(3), added by the Revenue Reconciliation Act of 1989) and of more value than the former ability to depreciate a trademark over its actual useful life, which was often indeterminate. Int. Rev. Code § 197(d)(1)(F) and (f)(4); Treas. Reg. § 1.197-2(b)(10). See also I.R.S. Private Letter Ruling 9630015, dated April 26, 1996; Treas. Reg. § 1.263A-1(e)(3)(ii)(U).

3. Since Section 197 also permits a taxpayer to amortize goodwill over the same period of time (see Int. Rev. Code § 197(d)(1)(A)), separating the cost of goodwill from the cost of a trademark when assets constituting a trade or business are acquired may be less critical than it has been in the past.

   a. Note that the House Report on the 1993 legislation in effect directed the Treasury Department to treat all amortizable Section 197 intangibles as Class IV assets under Section 1060 (see H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 776 (1993)), and the instructions to Form 8594 (Rev. 1-96) took this position.

   b. However, the temporary regulations under Sections 338 and 1060 published in January of 1997 created two intangible classes: Class IV, consisting of all Section 197 intangibles (except those in the nature of goodwill and going concern value), whether or not amortizable under Section 197, and Class V, consisting of the goodwill and going concern value excluded from Class IV.

Temporary Treas. Reg. §§ 1.338(b)-2T(b)(2) and 1.1060-1T(d)(2). Form 8594 (Rev. 7-98) reflected this position.

c. The final regulations under Sections 338 and 1060 published in February of 2001 place all Section 197 intangibles (except goodwill and going concern value) in a new Class VI, place goodwill and going concern value (whether or not qualifying as Section 197 intangibles) in a new Class VII, and characterize Class V as the residual class. Treas. Reg. §§ 1.338-6(b)(2) and 1.1060-1(a)(1). Form 8594 (Rev. 10-2002) reflects this position.

d. With respect to the allocation among partnership assets, including intangibles, of an adjustment to the basis of partnership assets incident to the sale or exchange of a partnership interest or the death of a partner, see T.D. 9059, 68 Fed. Reg. 34293.

I. A taxpayer with business operations both in the United States and abroad who is deemed to have purchased intellectual property will need to determine the source of the purchase price, when deductible, in order to determine the foreign tax credit available to offset his or its U.S. tax liability (see the discussion above).

1. The deduction sourcing rules applicable to a taxpayer who licenses intellectual property on a non-exclusive basis apply to a purchaser of intellectual property as well.

2. However, to the extent any portion of the purchase price is recharacterized as interest (see the discussion below of the transferor's tax treatment), special sourcing rules applicable to interest payments will also apply. See Treas. Reg. § 1.861-10; Temporary Treas. Reg. §§ 1.861-9T through 1.861-13T.

J. A purchaser who acquires intellectual property from a seller who is a non-resident alien individual, a foreign corporation, or a foreign partnership must determine

whether U.S. taxes are required to be withheld from the purchase price. The buyer's withholding obligations are dependent upon the nature of the payments.

1. The payments made to a seller may include compensation for services performed and unstated interest on that portion of the price not payable when the sale occurs.

2. If a non-resident alien individual, a foreign corporation, or a foreign partnership sells a patent, copyright, secret process and formula, trademark, or similar property in exchange for payments contingent on the productivity, use, or disposition of the property transferred and thereby realizes gain sourced in the United States because the property sold is to be used in the United States (see Int. Rev. Code §§ 861(a)(4), 865(d)(1)(B), 871(a)(1)(D), and 881(a)(4)), withholding at the statutory rate of 30% or at the lower treaty rate will be required (see Int. Rev. Code §§ 1441 and 1442), generally unless the payments are effectively connected with the seller's conduct of a trade or business in the United States and thereby includable in the seller's U.S. tax base under Section 871(b) or 882(a) (see Int. Rev. Code § 864(c)(2)). For a discussion of this provision and the law in effect before 1967, see Revenue Ruling 71-231, 1971-1 Cum. Bull. 229. See also *Commissioner v. Celanese Corp. of America*, 140 F.2d 339 (D.C. Cir. 1944).

3. Other gains, however, will be exempt from withholding, assuming that back-up withholding at the rate of 31% is not required (see Int. Rev. Code §§ 3406, 6041, and 6045).

   a. Nevertheless, these other gains may be taxable under the tax code provision (Int. Rev. Code § 871(a)(2)) dealing with U.S. source capital gains realized by non-resident aliens present in the United States for at least 183 days. See Revenue Ruling 78-253, 1978-1 Cum. Bull. 220, and the proposed repeal of this provision in the

Jumpstart Our Business Strength Act passed by the Senate on May 11, 2004 (H.R. 1637).

b. Such gains may be includable in the seller's U.S. tax base should the seller maintain a fixed place of business in the United States through which the sale is made (see Int. Rev. Code § 865(e)(2), dealing with the sale or exchange of a capital asset). See also Int. Rev. Code § 864(c)(4)(B)(iii).

4. If any portion of the purchase price is viewed as interest, withholding on the interest portion may not be required if it is viewed as original issue discount on portfolio indebtedness. See Int. Rev. Code §§ 871(a)(1)(A) and (C), 871(h)(2), 881(a)(1) and (3), and 881(c)(2). For a situation involving original issue discount associated with the acquisition of patent rights, see I.R.S. Field Service Advice 199922024, dated June 4, 1999.

5. Nor, to the extent the payments are found to constitute compensation for services rendered, will withholding be required if the services were performed outside of the United States. See Revenue Ruling 55-17, *supra*, and Proposed Treas. Reg. § 1.861-4(b), discussing the source of income from services performed partly within and partly outside of the United States.

TRANSFERRING INTELLECTUAL PROPERTY TO AN UNRELATED THIRD PARTY

I. **Nature of the Income**.

A. While the person acquiring intellectual property is concerned about the deductibility of the consideration paid, the transferor wants to know how the payments received will be taxed.

B. If there are foreign operations, the transferor of intellectual property will want to know whether the payments received are sourced in the United States or abroad.

C. In a world in which ordinary income and capital gains are taxed at different rates, it is also important to know whether the consideration paid to the transferor of intellectual property is capital or ordinary in nature.

1. Note, however, that even if the transferor is deemed to have sold a capital asset, there will be some ordinary so-called recapture income if the transferor previously was able to depreciate or amortize the cost of the asset. Int. Rev. Code § 1245. Intangible property, the cost of which is now amortizable over a period of 15 years, is treated as depreciable property for this purpose. See Int. Rev. Code § 197(f)(7); Treas. Reg. § 1.197-2(g)(8).

2. On the other hand, an amount equal to the research and experimental expenditures traceable to the property sold that a taxpayer elects to expense under Section 174(a) will not be subject to taxation at ordinary income rates when the taxpayer later sells the resulting technology at a gain. See Revenue Ruling 85-186, 1985-2 Cum. Bull. 84, rejecting the applicability of the so-called tax benefit doctrine under these circumstances. With respect to research and experimental expenditures that a taxpayer elects to deduct over a period of time, see Int. Rev. Code § 1016(a)(14) and Treas. Reg. § 1.1016-5(j) (dealing with Section 174(b) amounts), and Int. Rev. Code § 1016(a)(20) and I.R.S. Private Letter Ruling 200117006, dated January 17, 2001 (dealing with Section 59(e) amounts).

D. Even in a world in which ordinary income and capital gains are taxed at the same rate, the nature of the consideration may be important.

1. If the transferee of intellectual property is a non-resident alien individual or a foreign entity and there is a tax treaty in effect between the United States and

the transferee's home country, the label ascribed to the consideration may affect the tax treatment of the transaction. See *Boulez v. Commissioner*, 83 T.C. 584 (1984).

2. With respect to the characterization of royalty income for foreign tax credit purposes, see *American Air Liquide, Inc. v. Commissioner*, *supra*.

E. Similarly, under certain tax code provisions, royalty income, in contrast to capital gain, is, in effect, tainted or, conversely, afforded favorable treatment.

1. For example, the consideration received may cause a corporation to be treated as a so-called personal holding company that is required to pay an additional tax (under the tax code as amended in 1993, at the rate of 39.6% in taxable years beginning after 1992 but before 2001) on its undistributed personal holding company income. Int. Rev. Code § 541. See *Tomerlin Trust, Transferee v. Commissioner*, 87 T.C. 876 (1986). The current rate on undistributed personal holding company income is 15%, reflective of the changes in the taxation of dividends made by the Jobs and Growth Tax Relief Reconciliation Act of 2003.

a. Personal holding company income does not include gain from the sale of intellectual property, but it generally includes royalties received for the privilege of using patents, copyrights, secret processes and formulas, trademarks, and similar property. Int. Rev. Code § 543(a)(1); Treas. Reg. § 1.543-1(b)(3). See I.R.S. Private Letter Ruling 8450025, dated September 7, 1984.

b. However, personal holding company income does not include copyright royalties that comprise at least 50% of a corporation's ordinary gross income, provided that the royalties do not derive from works created in whole or in part by any shareholder of the

corporation and certain other statutory conditions regarding the makeup of the corporation's business deductions and non-copyright royalty income are met. Int. Rev. Code § 543(a)(4). See Treas. Reg. § 1.543-1(b)(12)(iv) regarding whether copyright protection is required both in the United States and abroad.

c. Since the Tax Reform Act of 1986, so-called active business computer software royalties, derived by a corporation actively engaged in the business of developing, manufacturing, or producing computer software, have also been excluded from personal holding company income. Int. Rev. Code § 543(a)(1)(C). To qualify for this exclusion, the computer software royalties must comprise at least 50% of the corporation's ordinary gross income and a number of other statutory requirements relating to the dividends paid by the entity and the nature of its tax deductions must be met. Int. Rev. Code § 543(d).

2. An S corporation, more than 25% of whose gross receipts for a period of three consecutive taxable years consist of passive investment income, and that has accumulated earnings and profits (earned before it elected S corporation status) at the end of each of these three taxable years, will cease to be an S corporation. Int. Rev. Code § 1362(d)(3). Moreover, an S corporation with accumulated earnings and profits at the end of any one of its taxable years that also derives more than 25% of its gross receipts from passive investment income during the same year may be required to pay a tax. Int. Rev. Code § 1375.

a. The passive investment income of an S corporation does not include gain from the sale of intellectual property, but it generally includes royalties for the privilege of using patents, copyrights, secret

processes and formulas, trademarks, and similar property. Int. Rev. Code § 1362(d)(3)(C)(i); Treas. Reg. § 1.1362-2(c)(5)(ii)(A)(1).

b. However, passive investment income includes neither (i) royalties derived by an S corporation in the ordinary course of its business of licensing property that it created or with respect to the development or marketing of which it performs significant services or incurs substantial costs, nor (ii) copyright royalties and active business computer software royalties that are not treated as personal holding company income. Treas. Reg. § 1.1362-2(c)(5)(ii)(A)(2) and (3).

3. An individual or a closely held corporation to which the passive activity loss (PAL) provisions of Section 469 apply may be adversely affected if income is characterized as a royalty.

a. If the royalty is viewed as passive in nature because the taxpayer does not materially participate in the trade or business activity from which it is derived, the income can be offset for tax purposes by passive losses. See Treas. Reg. §§ 1.469-2T(c)(3)(iii)(B) and 1.469-2T(f)(7).

b. Conversely, pure royalty income not derived in the ordinary course of a trade or business (and gain derived from the sale or exchange, other than in the normal course of the taxpayer's trade or business, of intellectual property that yielded pure royalty income) will generally not be treated as passive income and hence cannot be offset by passive losses (Int. Rev. Code § 469(e)(1)(A)).

c. Note that under the passive activity provisions, a trade or business includes any activity involving research or experimentation (Int. Rev. Code § 469(c)(5)).

4. The nature of the consideration received by a foreign corporation with U.S. shareholders may similarly determine whether these shareholders will be taxable currently on all or some portion of the corporation's net income. Under current law, a U.S. shareholder of a so-called foreign personal holding company is subject to tax on his or its share of the corporation's undistributed foreign personal holding company income (see Int. Rev. Code § 551), while an at-least-10%-U.S. shareholder of a so-called controlled foreign corporation is taxable on his or its share of certain items of income (Subpart F income) realized by the corporation, including so-called foreign personal holding company income (see Int. Rev. Code § 951).

   a. Under Section 553, foreign personal holding company income does not include gain from the sale of any intellectual property, but it generally includes all royalties. Only active business computer software royalties (described above) are excluded. Note also that the foreign personal holding company provisions would be repealed by the Jumpstart Our Business Strength Act passed by the Senate on May 11, 2004 (H.R. 1637).

   b. Under Section 954(c), on the other hand, gain derived from the sale of intellectual property not sold in the ordinary course of a corporation's trade or business may under some circumstances be treated as foreign personal holding company income; but royalties derived from unrelated parties incident to the active conduct of a trade or business or, in general, from a related person for the use of, or the privilege of using, property within the same country in which the recipient was formed, will not constitute foreign personal holding company income.

5. The nature of the income that a foreign corporation with U.S. shareholders receives may also determine whether these shareholders will be required to

pay a deferral charge for in effect electing not to report their share of corporate income on a current basis.

a. Royalties, as well as gain from the sale of intellectual property not sold in the ordinary course of a trade or business, can cause a foreign corporation to be characterized as a so-called passive foreign investment company (PFIC), by increasing its so-called passive income. If a U.S. shareholder of a PFIC does not elect to include in income currently his or its share of the corporation's current ordinary earnings and net capital gain, distributions subsequently received by the shareholder from the corporation will be subject to a deferral charge (see Int. Rev. Code §§ 1291, 1293).

b. Royalties, for this purpose, however, do not include those that are not treated as foreign personal holding company income under Section 954(c), discussed above, and, in addition, royalties paid by a related person and allocable to that person's non-passive income. Int. Rev. Code § 1296(b).

6. See also Int. Rev. Code § 956A, added by the Omnibus Budget Reconciliation Act of 1993 and subsequently repealed, dealing with the taxation of a U.S. shareholder currently on his or its share of the excess passive assets of a controlled foreign corporation.

II. **Licensing Intellectual Property to a Third Party**.

A. If the owner of a patent, a copyright, know-how, or computer software licenses it to a third party on a basis that is not treated as a sale for tax purposes, the income received by the licensor will be subject to tax at ordinary income rates.

1. For two interesting rulings dealing with the tax treatment of non-exclusive licenses on the death of the author of various copyrighted literary works,

including the creation of a new tax basis on death, see I.R.S. Private Letter Ruling 9326043, dated April 2, 1993, and I.R.S. Private Letter Ruling 9549023 dated September 8, 1995.

2. For a case finding ordinary income where a taxpayer licensed technology to a Japanese corporation pursuant to a technology transfer agreement that was terminable at will after 10 years (before the end of the useful life of the technology involved) and that did not thereafter preclude the taxpayer from disclosing the know-how to others in the transferee's exclusive territory, see *Henry Vogt Machine Co. v. Commissioner*, T.C. Memo 1993-371. Also with respect to know-how, see *Pickren v. United States*, 378 F.2d 595 (5th Cir. 1967).

3. For an interesting case dealing with the licensing of broadcasting rights, see *The Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108 (Pa. S.C. 2003), in which the Court treated the license payments as copyright royalties.

B. More complex statutory provisions apply when a trademark is licensed on a non-exclusive basis. However, they produce the same result, whether or not the royalty payments are contingent on the productivity, use, or disposition of the trademark.

1. To the extent the royalty payments are contingent on the productivity, use, or disposition of the trademark, the transferor will be treated as having received income from the sale or other disposition of a non-capital asset – that is, ordinary income. Int. Rev. Code § 1253(c). With respect to prior law, see *Dairy Queen of Oklahoma, Inc. v. Commissioner*, 250 F.2d 503 (10th Cir. 1957).

2. If the transferor retains any significant power, right, or continuing interest in the trademark, but does not receive payments contingent on the productivity, use, or disposition of the trademark, it is reasonable to conclude that all income will also be treated as ordinary income by reason of Section 1253(a), which states that the transaction will not be treated as a sale or exchange of a capital asset. Under this provision, for example, a sale will not be deemed to have occurred if the transferor retains the right:

   a. To set quality standards for the products to which the trademark is affixed (Int. Rev. Code § 1253(b)(2)(C)), or

   b. To require the transferee to advertise only the licensor's products (Int. Rev. Code § 1253(b)(2)(D)), where, according to the Tax Court, the retained right is co-extensive with the duration of the interest transferred. *Stokely U.S.A., Inc. v. Commissioner*, 100 T.C. 439 (1993).

C. A transferor with business operations both within the United States and abroad must determine the source of any royalty income derived from licensing intellectual property, in order to determine the foreign tax credit available to offset his or its U.S. tax liability (see the discussion above). Special sourcing rules apply to royalty income, assuming it does not in fact represent compensation for services rendered (see Revenue Ruling 84-78, *supra*), normally sourced where the services were performed (see Int. Rev. Code §§ 861(a)(3) and 862(a)(3)).

1. Royalties paid for use in the United States of, or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, trademarks, and like property are sourced in the United States. Int. Rev. Code § 861(a)(4). Note, in this regard, the distinction drawn in Treas. Reg. § 1.861-18 between the lease of a copyrighted computer program (generating

rental income) and the license of the copyright right itself (generating royalty income).

2. Royalties paid for use abroad of, or for the privilege of using abroad, patents, copyrights, secret processes and formulas, trademarks, and like property are sourced outside of the United States. Int. Rev. Code § 862(a)(4).

3. Thus, the place where the licensee uses or is entitled to use the intellectual property is controlling. See Revenue Ruling 68-443, 1968-2 Cum. Bull. 304; Revenue Ruling 72-232, *supra*, and Revenue Ruling 74-555, 1974-2 Cum. Bull. 202; and *Sanchez v. Commissioner*, 6 T.C. 1141 (1946), dealing with trademark, copyright, and patent royalties, respectively.

III. **Assigning Intellectual Property to a Third Party.**

A. Conversely, if a taxpayer assigns his or its entire interest in intellectual property to a third party, or licenses the property on an exclusive basis to a third party, a sale will typically be deemed to have occurred for tax purposes, but the resulting income may not always be capital in nature.

B. Note that if the transaction involves cross-licenses of property not terminable at will by either party, it may qualify as a like-kind exchange.

1. Then, depending upon the facts, neither party to the transaction may be required to recognize any taxable income. See Int. Rev. Code § 1031, pursuant to which the properties involved must be held for productive use in a trade or business or for investment; I.R.S. Technical Advice Memorandum 9222005, dated January 10, 1992.

2. To determine whether intangible properties are of like kind, the regulations focus upon the nature or character of both the rights involved and the underlying properties to which the intangibles relate. For example, a

copyright on a novel and a copyright on a song are not deemed to be of like kind. Treas. Reg. § 1.1031(a)-2(c).

3. The Internal Revenue Service has concluded that a taxpayer could swap FCC broadcast station licenses on a tax-free basis, even though one related to radio and the other television. I.R.S. Technical Advice Memorandum 200035005, dated May 11, 2000. See also I.R.S. Technical Advice Memorandum 200224004, dated November 29, 2001.

C. Different rules apply to the sale of patents, copyrights, computer software, know-how, and trademarks. The discussion below assumes that the transaction does not involve a like-kind exchange.

D. Patents.

1. There is a statutory safe-harbor, that was adopted in 1954, pursuant to which an individual holder of a patent (see *Juda v. Commissioner*, 90 T.C. 1263 (1988), regarding partners) who transfers to an unrelated party all substantial rights to the patent or an undivided interest in all rights to the patent will realize long-term capital gain (or loss) regardless of whether or not the payments received in exchange are (i) payable periodically over a period generally co-terminus with the assignee's use of the patent (but see the discussion below), or (ii) contingent on the productivity, use, or disposition of the patent. Int. Rev. Code § 1235(a).

a. The regulations indicate that this safe-harbor provision can apply even before a patent has been granted or before a patent application has been filed (Treas. Reg. § 1.1235-2(a)), but the consequences, should a patent never issue, are not discussed. See *Gilson v. Commissioner*, T.C. Memo 1984-447. Also both U.S. and foreign patents are covered.

b. The holder of a patent will, according to the regulations, not be deemed to have disposed of all substantial rights to the patent if, for example, the transferee's rights are limited geographically within the country of issue (a provision found to be invalid in *Rodgers v. Commissioner*, 51 T.C. 927 (1969), but later found by the Tax Court to be valid), the transferee's rights do not extend throughout the remaining life of the patent, or the transferee is granted rights in fields of use within trades or industries that are less than all of the valuable rights covered by the patent. Treas. Reg. § 1.1235-2(b)(1) and (c).

c. Under the statutory safe-harbor provision, the holder of a patent is the individual whose efforts created the property, or any other individual unrelated to the inventor, such as a financial backer, who is not the inventor's employer and who acquired the inventor's interest in the patent for consideration before the invention was actually reduced to practice. Int. Rev. Code § 1235(b) and (d). An invention is reduced to practice once "it has been tested and operated successfully under operating conditions," but in no event later than when commercial exploitation occurs. Treas. Reg. § 1.1235-2(e). With respect to the treatment of partners as holders, see I.R.S. Private Letter Ruling 200135015, dated May 31, 2001, and I.R.S. Private Letter Ruling 200219017, dated February 6, 2002.

d. Nevertheless, an employee hired to invent will realize ordinary income and not capital gain if he is bound to assign to his employer all patents that he obtains and all patentable inventions that he conceives in the course of his employment. See Treas. Reg. § 1.1235-1(c)(2); *McClain v. Commissioner*, 40 T.C. 841 (1963); I.R.S. Technical Advice Memorandum 200249002, dated August 8, 2002. Note in this regard that the Internal Revenue Service has begun

to focus on equity-type compensation arrangements entered into with employees who invent. See *BNA Daily Tax Report* No. 79, at G-5 (April 24, 1998).

2. If the safe-harbor provision does not apply, capital gains treatment may still be available under general tax principles distinguishing capital assets from other property. See Revenue Ruling 69-482, 1969-2 Cum. Bull. 164. The availability of capital gains treatment will depend initially upon whether a sale is deemed to have occurred for tax purposes, applying principles of law in effect before 1954, as they have evolved since that time. In applying these provisions, it may be important to bear in mind why the safe-harbor provision does not apply. Even if a sale is deemed to have occurred, however:

   a. A professional inventor who is in the business of inventing and selling patents will realize ordinary income (see *Avery v. Commissioner*, 47 B.T.A. 538 (1942)).

   b. A seller who used the patent in the ordinary course of his or its trade or business will derive either a capital gain or an ordinary loss under the provisions of Section 1231 (see Int. Rev. Code § 1221(2), indicating that depreciable property used in a trade or business does not constitute a capital asset).

   c. Finally, while an amateur inventor will realize capital gain, the gain will be short-term in nature if the sale occurs before the patent is actually reduced to practice (see *Burde v. Commissioner*, 43 T.C. 252 (1964)) — that is, before property rights in the patent come into being (see *Diescher v. Commissioner*, 36 B.T.A. 732 (1937)).

3. However, if the patent was depreciable, an amount of gain equal to the depreciation deductions available to the assignor before the transfer occurred

(whether or not claimed) will be treated as ordinary income and not capital gain. Int. Rev. Code § 1245.

4. In addition, even if the transferor of a patent realizes capital gain, some portion of the transfer price, if payable over time, may be treated as interest under the imputed interest provisions in the tax code if there is no stated interest or if the interest to be paid falls short of the statutory safe-harbor amount.

   a. If the transfer is described in Section 1235(a) and the consideration is contingent on the productivity, use, or disposition of the property transferred, the imputed interest provisions will not apply. Int. Rev. Code §§ 483(d)(4) and 1274(c)(3)(E). Although the Internal Revenue Service has held that a transfer is described in Section 1235(a) even though Section 1235 does not apply because the recipient of the property is a related party (Revenue Ruling 78-124, 1978-1 Cum. Bull. 147), the Senate Report on the Tax Reform Act of 1984 indicates that a transfer that does not actually qualify for capital gains treatment under Section 1235 will be subject to the imputed interest provisions. See S. Rep. No. 98-169 (Vol. I), 98th Cong., 2d Sess. 258, n. 15 (1984).

   b. In all other cases, one of two imputed interest provisions (Section 483 or 1274) may apply. If the consideration paid totals no more than $250,000 (a fact that may be difficult to ascertain when the price is contingent), the provisions of Section 1274 will not apply. Int. Rev. Code § 1274(c)(3)(C). Instead, under Section 483, some portion of each payment due more than six months after the sale will be recharacterized as interest if the sale price exceeds $3,000, the interest provided for is less than the statutory safe-harbor amount (see Int.

Rev. Code §§ 1274(d) and 1274A(a) and (d)(2)), and some portion of the price is payable more than one year after the sale occurs.

c. In general, if the provisions of Section 1274 apply, original issue discount will be imputed if the interest provided for is inadequate (under Int. Rev. Code § 1274(d) or 1274A(a) and (d)(2)), and the transferor will be required to include some portion of this original issue discount in gross income, as ordinary income, each year while the transfer price remains outstanding, without regard to when payments are actually made. Int. Rev. Code §§ 1272 and 1273. However, under some circumstances, a special election to report imputed interest as payments are made may be available. See Int. Rev. Code § 1274A(c) and (d); Revenue Ruling 2002-79, 2002-48 Int. Rev. Bull. 908.

5. When some part of the transfer price is payable over time, the transferor must also determine when the property's tax basis, if any, can be recovered tax-free.

a. If the sale price is fixed in amount and duration and the taxpayer, if permitted to do so, chooses to report gain on the installment method (Int. Rev. Code § 453), the taxpayer will merely recover his or its basis in the property transferred proportionately as payments of principal are made. Note that the provision limiting the use of the installment method to cash method taxpayers (Int. Rev. Code § 453(a)(2), as amended by the Ticket to Work and Work Incentives Improvement Act of 1999) was repealed by the Installment Tax Correction Act of 2000. However, the tax attributable to depreciation recapture must be paid in the year of sale. Also, with respect to the

deferral charge that may be due if installment reporting is selected, see Int. Rev. Code § 453A.

b. If the purchase price is contingent in amount or in duration, or both, the proration formula under the installment method can work only if certain assumptions about the price are made. The regulations indicate what to do when either (i) a stated maximum selling price can be ascertained by assuming all contingencies are met in a manner that will maximize the price and accelerate payments to the earliest permitted time, or (ii) the maximum period over which payments can be made is fixed. The regulations go on to provide for the recovery of basis ratably over a period of 15 years if there is neither a stated maximum selling price nor a fixed payout period. When any contingent payment sale occurs, however, the taxpayer may seek permission from the Internal Revenue Service to use a different basis recovery method. See Treas. Reg. § 15A.453-1(c) that also recognizes the income forecast method for basis recovery under appropriate circumstances; and *AMC Partnership v. Commissioner*, T.C. Memo 1997-115.

c. The so-called open transaction method of reporting a transaction, pursuant to which a taxpayer elects out of installment sale reporting and recovers basis first, is likely to be challenged by the Internal Revenue Service. The regulations state: "Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.'" Treas. Reg. § 15A.453-1(d)(2)(iii). See *Burnet v. Logan*, 283 U.S. 404 (1931).

E. Copyrights.

1. There is less question about the nature of income derived from the transfer of a copyright, once the transaction has been determined to be a sale for tax purposes rather than a non-exclusive license or a payment of compensation for services rendered. See Revenue Ruling 84-78, *supra*; Revenue Ruling 75-202, 1975-1 Cum. Bull. 170; Revenue Ruling 60-226, *supra*; *Boulez v. Commissioner*, *supra*. In the *Boulez* case, applying the "works for hire" rule, the Tax Court found that the taxpayer had no copyrightable property interest in the recordings he made for a recording company, and that hence, he realized compensation income.

2. The tax code specifically states that the term "capital asset" does not include a copyright held by the person whose personal efforts created it or to whom it was assigned by the creator in a carryover basis transaction (for example, as a gift). Int. Rev. Code § 1221(3), applicable to any property eligible for copyright protection under statute or common law, but not applicable to a design that may be protected solely under the patent law. See Treas. Reg. § 1.1221-1(c)(1).

   a. The income derived from the sale of a copyright that is not a capital asset for this reason will always be ordinary in nature. See Int. Rev. Code § 1231(b)(1)(C), that prevents any such gain from being treated as capital in nature, and *Meisner v. United States,* 133 F.3d 654 (8th Cir. 1998).

   b. However, the transferor should be able to recover his or its cost basis tax-free because, under the circumstances, the statute does not negate "sale or exchange" treatment.

3. In other cases, the transferor will realize capital gain, provided that:

a. The copyright was not held for sale to customers in the ordinary course of the transferor's trade or business (see Int. Rev. Code § 1221(1); *Desilu Productions, Inc. v. Commissioner*, T.C. Memo 1965-307);

b. The copyright was not used in the transferor's trade or business (see Int. Rev. Code § 1221(2)), or, if it was, the provisions of Section 1231 do not in effect cause the income to be recharacterized as ordinary in nature; and

c. No portion of the price is imputed as interest under the provisions of Section 483 or Section 1274 discussed above.

F. Computer Software.

1. In view of the fact that some computer software is now copyrightable and patentable, it is not clear whether the sale of computer software must be analyzed as though it were the sale of a copyright or patent. The regulations under Section 1221 confuse the issue by specifically excluding from the term "capital asset" any property eligible for copyright protection, presumably whether or not formal copyright protection is sought. Treas. Reg. § 1.1221-1(c)(1). Cf. *Microsoft Corp. v. Commissioner*, 311 F.3d 1178 (9th Cir. 2002), dealing with the tax treatment for other purposes of master copies of Microsoft computer software.

2. Nor is it clear whether, without the benefit of copyright or patent status, computer software can qualify as property and hence a capital asset, at least when it is not viewed by the owner as a trade secret. See the discussion of know-how below. Note, however, that Section 167(f) treats the computer software to which it applies as property.

3. The final regulations promulgated under Section 861 are helpful, but not determinative, on the subject of what a transfer of computer software actually entails. These recognize that the transfer of a computer program may involve one or more of the following: the transfer of a copyright right in the program, the transfer of a copy of the computer program, the provision of services for the development or modification of the program, or the provision of know-how relating to computer programming techniques. Treas. Reg. § 1.861-18(b).

4. In any event, sales of computer software in the consumer market will generate ordinary income, whether the transaction is viewed as a sale or a license for tax purposes. See Int. Rev. Code §§ 1221(1) and 1231(b)(1)(A).

5. Moreover, under certain circumstances, computer software may be deemed not to have been transferred separately, leaving the tax consequences of the transfer dependent upon the tax impact of the underlying transaction. For example, in *Syncsort, Inc. v. United States*, 31 Fed. Cl. 545 (Ct. Cl. 1994), dealing with certain license agreements pursuant to which the taxpayer granted each licensee an exclusive license to exploit its computer program in a specified geographic area and agreed to permit the licensees to use certain technological information and trade secrets, the court viewed the entire transaction as a franchise, handled like trademarks under the tax code.

G. Know-How.

1. There are no statutory provisions dealing specifically with the disposition of know-how.

2. Under appropriate circumstances, however, know-how may be classified as a capital asset or may qualify for favorable tax treatment under Section 1231,

so that when a sale is deemed to have occurred, a taxpayer who disposes of know-how can realize capital gain.

a. Of primary concern here is whether know-how constitutes property. If it does not, it cannot qualify as a capital asset (Int. Rev. Code § 1221) or as an asset eligible for the benefits of Section 1231.

b. In the past, the Internal Revenue Service treated trade secrets as property (see Revenue Ruling 71-564, *supra,* dealing with the transfer of trade secrets to a corporation), leaving doubt about the nature of other technological information. See also *Pickren v. United States, supra,* describing secret formulas as capital assets.

c. Nevertheless, prior case law supports property characterization under other circumstances. See *Henry Vogt Machine Co. v. Commissioner, supra* (in which confidential, unpatented technology was viewed as property), and *Ofria v. Commissioner*, 77 T.C. 524 (1981) (where engineering proposals were found to incorporate "trade secrets, know-how, or unpatented technology protectable as a form of property").

d. Moreover, the final regulations under Section 197 treat an amortizable Section 197 intangible held by a taxpayer for more than one year as an asset eligible for the benefits of Section 1231. See Treas. Reg. § 1.197-2(g)(8), and compare Int. Rev. Code § 197(f)(7), treating any amortizable Section 197 intangible as "property" subject to the allowance for depreciation. See also Proposed Treas. Reg. § 1.197-2(g)(7)(ii)(B), which declined to treat know-how to which the provisions of Section 197 apply as property for all purposes under the tax code.

3. Assuming there is no imputed interest, a taxpayer who sells know-how that is treated as property will recognize capital gain unless (i) the know-how is deemed to have been sold to customers in the ordinary course of the taxpayer's trade or business, (ii) the gain is in effect recharacterized as ordinary income under Section 1231, or (iii) the taxpayer is a professional inventor or an employee who is obligated to sell all inventions to his employer. See *Taylor-Winfield Corp. v. Commissioner*, 57 T.C. 205 (1971).

4. If the taxpayer has any basis in the transferred know-how, it will reduce the taxpayer's income either currently or over time (see the discussion above).

5. By way of footnote, however, it is important to note that under certain circumstances, know-how may be deemed not to have been separately transferred, leaving the tax consequences of the transfer dependent upon the tax impact of the underlying transaction. See *Syncsort, Inc. v. United States, supra.*

H. Trademarks.

1. The nature of the income that a taxpayer receives upon disposing of a trademark without retaining any significant power, right, or continuing interest with respect to the subject matter of the trademark will depend upon the nature of the consideration paid.

   a. The tax code states that if the taxpayer receives amounts contingent on the productivity, use, or disposition of the trademark, these amounts will be treated as received from the sale or other disposition of a non-capital asset. Hence, there will be ordinary income. Int. Rev. Code § 1253(c). However, since Section 1253(c) does not negate the occurrence of a "sale or exchange," the taxpayer will presumably not be taxed on his or its basis in the property transferred.

b. Otherwise, the general tax principles distinguishing ordinary income from capital gain, which are discussed above, will apply. These general principles will apply, for example, when a taxpayer unconditionally sells a trademark and all of the other assets used in the taxpayer's business in exchange for a lump-sum amount.

2. On the other hand, a taxpayer who disposes of a trademark and retains any significant power, right, or continuing interest with respect to the subject matter of a trademark (such as quality control rights) will not be deemed to have sold or exchanged a capital asset (Int. Rev. Code § 1253(a) and (b)(2)), and hence will realize ordinary income.

a. Note that a taxpayer will be deemed to have retained a significant continuing interest in a trademark when a substantial portion of the consideration consists of a right to payments contingent on the productivity, use, or disposition of the trademark. See Int. Rev. Code § 1253(b)(2)(F).

b. Nevertheless, for purposes of determining whether or not the transaction gives rise to personal holding company income, the transaction may still be regarded as a sale. See *Tomerlin Trust, Transferee v. Commissioner*, *supra*.

I. A taxpayer who conducts business both in the United States and abroad must determine the source of his or its income derived from assigning or licensing intellectual property in a transaction that is viewed as a sale for tax purposes, in order to determine the foreign tax credit available to offset his or its U.S. tax liability (see the discussion above).

1. There is a special tax code provision, added by the Tax Reform Act of 1986, dealing with the source of income that a taxpayer realizes when personal property is sold.

2. In general, from the sale of personal property, a U.S. resident taxpayer:

   a. Will realize U.S. source income if the property is neither inventory nor depreciable and if the taxpayer does not maintain a fixed place of business abroad to which the sale can be attributed. See *International Multifoods Corp. v. Commissioner*, 108 T.C. 25 (1997).

   b. May realize foreign source income if the property is inventory or depreciable or if the taxpayer maintains a fixed place of business abroad to which the sale can be attributed. Int. Rev. Code § 865(a) through (c), (e). See I.R.S. Private Letter Ruling 9612017, dated December 20, 1995.

3. Intangibles, on the other hand, including patents, copyrights, secret processes or formulas, and trademarks, are treated differently from other personal property. Int. Rev. Code § 865(d). Note, however, that under certain circumstances, the Internal Revenue Service may regard the transfer of an intangible as incidental to the transfer of other personal property, in which case the special sourcing rules for intangibles will not apply. See Revenue Ruling 75-254, 1975-1 Cum. Bull. 243, dealing with the sale of a trademarked product. Note also that Treas. Reg. § 1.861-18 treats the transfer of a copy of a computer program as the transfer of a copyrighted article, not the transfer of a copyright right.

   a. If the consideration received by a taxpayer for an intangible (not deemed to have been transferred incident to the transfer of other personal property) is not contingent on the productivity, use, or

disposition of the intangible, the general rules under Section 865 noted above (except for Section 865(c)(2), relating to gain in excess of depreciation) will normally apply.

b. On the other hand, any consideration contingent on the productivity, use, or disposition of the intangible will normally be treated as a royalty, and the special royalty sourcing rules described earlier in this outline will apply, but only to the extent that the gain exceeds any tax depreciation allowable with respect to the property sold.

c. Under either of these two alternatives, gain equal to the allowable depreciation will be divided between U.S. and non-U.S. source income, based upon the proportionate amount of the depreciation adjustments allocable to each source, if tax depreciation was allowable with respect to the property sold. For this purpose, depreciation may include any deductions for research and experimental expenses claimed under Section 174.

d. Notwithstanding these provisions, however, a taxpayer may elect the benefits of Section 865(h), pursuant to which gain derived from the sale of an intangible will be sourced outside of the United States if, under a treaty obligation, it would be sourced abroad.

4. For rules dealing with the sourcing of any portion of the purchase price recharacterized as interest or compensation, see Int. Rev. Code §§ 861(a)(1) and 862(a)(1) (as to interest) and Int. Rev. Code §§ 861(a)(3) and 862(a)(3) (as to compensation).

5. Note that, in some situations, the inventory sourcing rules (see Treas. Reg. § 1.863-3 and Treas. Reg. § 1.861-7(c)) will apply. This can occur if the

property in question is deemed to be a copyrighted article, rather than a copyright right, pursuant to Treas. Reg. § 1.861-18.

RELATED PARTY TRANSACTIONS

I. **Intercompany Transactions**.

A. Intercompany Pricing.

1. Section 482 broadly states that the Internal Revenue Service may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses (whether or not incorporated, affiliated, or organized in the United States) that are owned or controlled by the same interests if it determines that such a distribution, apportionment, or allocation is necessary to prevent the evasion of taxes or clearly to reflect income. See generally the Internal Revenue Service's *Foreign Controlled Corporation Non-CEP Transfer Pricing Audit Guide*, made available in 1998, and I.R.S. Publication 3218, *Report on the Application and Administration of Section 482*.

a. The Service will apply an arm's-length standard to determine whether a transaction produces results consistent with those that would have been realized if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances. Treas. Reg. § 1.482-1A(b)(1); Treas. Reg. § 1.482-1(b)(1). Under the final regulations issued on July 1, 1994, comparability will be evaluated by taking into account functions, contractual terms, risks, economic conditions, and the nature of the property or services. Treas. Reg. § 1.482-1(d)(1).

b. The Service need not establish fraud, improper accounting, or tax avoidance. Treas. Reg. § 1.482-1A(c); Treas. Reg. § 1.482-1(f)(1)(i).

c. With respect to the control requirements of Section 482, see *W.L. Gore & Associates, Inc. v. Commissioner*, T.C. Memo 1995-96, and I.R.S. Field Service Advice 200230001, dated March 25, 2002. See also I.R.S. Technical Advice Memorandum 9222005, dated January 10, 1992, in which the Service took the position that Section 482 can apply even to cross-licensing arrangements to which the like-kind exchange provisions of Section 1031 apply.

2. Should the Section 482 adjustment made by the Internal Revenue Service be substantial (that is, for any year beginning after 1993, the price shown on a return is at least 200% more than or 50% less than the amount determined to be correct, or there is a net Section 482 transfer price adjustment of more than $5 million or, if less, 10% of the taxpayer's gross receipts), the taxpayer may be subject to a 20% (or 40%, in the case of a gross valuation misstatement) accuracy-related penalty under Section 6662.

a. There are actually two types of Section 482 penalties under this provision — a "transactional penalty" and a "net adjustment penalty." See Treas. Reg. § 1.6662-6(a)(1).

b. The former penalty applies when a transaction between persons described in section 482 involves a valuation misstatement. For a recent case in which the 40% penalty imposed as the result of a trademark adjustment was reversed on appeal, see *DHL Corp. v. Commissioner*, 285 F.3d 1210 (9th Cir. 2002).

c. The latter penalty applies when taxable income increases by reason of an allocation under Section 482. It can be avoided under certain

defined circumstances – for example, if the taxpayer produces, within 30 days of being asked for it, documentation that was in existence when the applicable tax return was filed, substantiating that the price was determined using a specific pricing method prescribed by regulation, and that the selection and application of the method chosen was reasonable. See Treas. Reg. § 1.6662-6(d). See also Revenue Procedure 94-33, 1994-1 Cum. Bull. 628; I.R.S. Announcement 96-16, 1996-13 Int. Rev. Bull. 22.

d. However, the net adjustment penalty cannot be avoided under the general statutory exception for reasonable cause. See Int. Rev. Code §§ 6662(e)(3)(D) and 6664(c). Cf. Treas. Reg. § 1.6662-6(b)(3); Temporary Treas. Reg. § 1.6664-4T(f).

3. The old regulations under Section 482 included a section dealing specifically with the transfer or use of intangible property (Treas. Reg. § 1.482-2A(d), applicable in taxable years beginning on or before April 21, 1993). In 1986, however, Section 482 was expanded to provide that whenever an intangible, such as a patent, copyright, know-how, or trademark, is licensed or transferred, the income earned must be commensurate with the income attributable to the intangible. This is the so-called "super-royalty" provision.

a. Hence, if one member of a controlled group licenses or assigns intellectual property to another member of the group, the consideration paid cannot be based simply on industry norms or other unrelated party transactions. See Treas. Reg. § 1.482-4(f)(4) (to be renumbered as § 1.482-4(f)(5) upon the adoption of proposed regulations under Section 482 published in the *Federal Register* on September 10, 2003).

b. Moreover, the consideration paid in a related party transaction may need to be adjusted over time to reflect the actual profits of the transferee attributable to the intangible in question. See Treas. Reg. §§ 1.482-4(f)(2) (dealing with periodic adjustments) and 1.482-4(f)(5) (dealing with lump sum payments), to be renumbered as § 1.482-4(f)(6) upon the adoption of proposed regulations under Section 482 published in the *Federal Register* on September 10, 2003.

c. If the transferor retains a substantial interest in the property and receives nothing or only nominal consideration in exchange, an arm's-length royalty will typically be imputed. See Treas. Reg. § 1.482-4(f)(1).

d. More generally, under the final regulations, one of four methods must be applied to determine whether the consideration satisfies the general arm's-length standard: the so-called comparable uncontrolled transaction (CUT) method, the comparable profits method (CPM), the profit split method, and any other method (an unspecified method) that satisfies the criteria set forth in the regulations. Treas. Reg. § 1.482-4(a). The method chosen must be applied in accordance with the general requirement that the results of the transaction in question not fall outside of an arm's-length range of results achieved in comparable transactions involving uncontrolled taxpayers. See Treas. Reg. § 1.482-1(e).

e. A taxpayer is required to choose that method which produces the most reliable measure of an arm's-length result under the facts and circumstances of the transaction under review (the so-called best method), taking into account comparability and the quality of data and

assumptions. Treas. Reg. § 1.482-1(c); see, *e.g.*, Treas. Reg. § 1.482-4(c)(2)(i).

f. Consistent with this approach, the final regulations generally view the comparable profits method as a method of last resort. See Treas. Reg. § 1.482-5; Treasury Decision 8552, 1994-2 Cum. Bull. 93, at 109.

g. With respect to the ownership of intangible property for Section 482 purposes, see Treas. Reg. § 1.482-4(f)(3), Proposed Treas. Reg. § 1.482-4(f)(3), and *Medieval Attractions N.V. v. Commissioner*, T.C. Memo 1996-455.

h. With respect to the imputation of an agreement relating to the use of a trademark or the marketing of an intangible, see Proposed Treas. Reg. § 1.482-4(f)(4).

4. Bona fide research and development cost-sharing arrangements are still permitted, to the extent they are consistent with the purpose of the amendment to Section 482, namely, "that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each." H.R. Rep. No. 99-841 (Vol. II), 99th Cong., 2d Sess. II-638 (1986).

a. A cost-sharing arrangement is a written arrangement pursuant to which two or more members of a controlled group agree upon the costs and risks they will bear in connection with the development of intellectual property in which each will have an interest. The arrangement differs from a partnership (see Treas. Reg. § 301.7701-3) in that once the property is developed, each party bears the costs of producing and marketing its interest in the property and retains the benefits of its own efforts.

b. According to the Conference Report on the 1986 Act, a cost sharer must bear its portion of the costs of developing both successful and unsuccessful products at all relevant stages of development. H.R. Rep. No. 99-841 (Vol. II), 99th Cong., 2d Sess. II-638 (1986).

c. In January of 1992, the Treasury Department issued a proposed regulation (Proposed Treas. Reg. § 1.482-2(g)) on the subject of cost-sharing arrangements, that incorporated the commensurate-with-income standard and that has since been finalized. Treas. Reg. § 1.482-7, as amended by Treasury Decision 8670, published in the *Federal Register* on May 13, 1996, applicable in taxable years beginning after 1995.

d. Under the final cost-sharing regulation, the Internal Revenue Service will not disturb the way in which the parties to a cost-sharing arrangement agree to share the costs of developing intangibles, so long as their agreement qualifies under the standards set forth in the regulation, and the Service finds it unnecessary to adjust a controlled participant's share of costs to cause them to equal that participant's share of the reasonably anticipated direct or indirect benefits derived from the intangibles. Cf. Treas. Reg. § 1.482-7(d), dealing with the treatment of stock-based compensation under a cost sharing arrangement.

e. See I.R.S. Field Service Advice 200001018, dated January 7, 2000, and I.R.S. Field Service Advice 200023014, dated February 29, 2000, discussing cost-sharing arrangements. Note that cost-sharing payments for the right to use intangibles have been held to be ineligible for Section 174 treatment. See I.R.S. Field Service Advice 200122005, dated February 1, 2001. In addition, research or

experimental expenditures covered by cost-sharing payments are not eligible for Section 174 treatment. See I.R.S. Field Service Advice 200207012, dated November 13, 2001.

5. Several consolidated U.S. Tax Court cases involving Nestle Holdings, Inc. and transfer pricing issues commonly faced by those who license intellectual property from a related party received wide publicity in 1994.

   a. Among the issues that the court was asked to address were the deductibility of royalties paid and the reasonableness of research and development fees. See Tax Court Docket Nos. 21558-90 through 21562-90 and 12245-91 and *BNA Daily Tax Report* No. 195, at G-2 (Oct. 12, 1994).

   b. The cases were widely publicized in 1994 because of a letter that the office of the North Atlantic Regional Counsel sent to several large manufacturing companies requesting information relevant to the issues raised, such as identification of the companies' unsuccessful attempts to license their trademarks. See *BNA Daily Tax Report* No. 66, at J-1 (April 7, 1994). Note that the Internal Revenue Service has in the past indicated that under appropriate circumstances, it will use its summons authority to obtain comparable information from third parties. See *BNA Daily Tax Report* No. 220, at G-3 (Nov. 17, 1994).

6. For special rules dealing with the tax treatment of the intangible property income of a U.S. possessions corporation, see Int. Rev. Code § 936(h) and *Altama Delta Corp. v. Commissioner,* 104 T.C. 424 (1995).

7. A number of programs have been developed to address transfer-pricing matters.

a. For a discussion of the government's advance pricing agreement (APA) program pursuant to which a taxpayer and the Internal Revenue Service can agree in advance on a transfer pricing method, see I.R.S. Announcement 96-124, 1996-49 Int. Rev. Bull. 22; Revenue Procedure 96-53, 1996-2 Cum. Bull. 375; and I.R.S. Manual Chapter (42)(10)00, issued January 22, 1997. See also a report appearing in *BNA Daily Tax Report* No. 11, at G- 1 (Jan. 20, 2003), indicating that APA cases were not being processed pending a Senate review of the program.

b. For a discussion of the small business taxpayer APA Program, see I.R.S. Notice 98-10, 1998-1 Cum. Bull. 424, and I.R.S. Notice 98-65, 1998-2 Cum. Bull. 803.

c. Early in 1999, the Internal Revenue Service agreed that redacted APAs were subject to disclosure. See *BNA Daily Tax Report* No. 69, at G-1 (April 12, 1999), discussing the position of the government in light of litigation brought by BNA seeking public disclosure of APAs. However, the Ticket to Work and Work Incentives Improvement Act 1999 amended the statute to treat APAs and related background information as confidential. Thus, neither is subject to public disclosure, but the Treasury Department is required to prepare an annual report providing information about APAs. See Int. Rev. Code §§ 6103(b)(2)(C) and 6110(b)(1), as amended; I.R.S. Announcement 2000-35, 2000-1 Cum. Bull. 922 (the first such report); I.R.S. Announcement 2001-32, 2001-17 Int. Rev. Bull. 1113 (the second such report); I.R.S. Announcement 2002-40, 2002-15 Int. Rev. Bull. 747 (the third such report); I.R.S. Announcement 2003-19, 2003-15 Int. Rev. Bull. 723 (the fourth such report); and I.R.S.

Announcement 2004-26, 2004-15 Int. Rev. Bull. 743 (the fifth such report).

d. For a discussion of another program available to taxpayers seeking to resolve Section 482 disputes with the Service, see Revenue Procedure 94-67, 1994-2 Cum. Bull. 800, dealing with the AIR (Accelerated Issue Resolution) program.

e. See also Revenue Procedure 96-13, 1996-1 Cum. Bull. 616, dealing with requests for assistance of the U.S. competent authority under the provisions of a tax treaty to which the United States is a party.

B. Conversion of Capital Gain into Ordinary Income.

1. Although the income that a taxpayer realizes when intellectual property is sold may be treated as capital gain for tax purposes, there are several tax code provisions that convert what might otherwise be capital gain into ordinary income when the parties to the transaction are related.

2. The special provision pursuant to which the holder of a patent can realize capital gain when he sells the patent does not apply if the purchaser is a related party. See Int. Rev. Code § 1235(d); *Soffron v. Commissioner*, 35 T.C. 787 (1961).

a. Capital gains treatment may still be available under general principles of tax law. See Revenue Ruling 69-482, *supra*.

b. However, the government will be reluctant to allow capital gains treatment where the transferor would have realized ordinary income had he, instead of the related party, exploited the patent. See *Van Dale Corp. v. Commissioner*, 59 T.C. 390 (1972), where the government sought to apply Section 482 (discussed above).

3. Under Section 1239, a taxpayer who sells property to a related person will realize ordinary income if the property is depreciable in the hands of the transferee, the concern here being with a taxpayer's ability to generate ordinary deductions in the future (through a related party) by paying currently a tax at favorable capital gain rates.

   a. A patent application is deemed to be depreciable for this purpose. However, since patents with respect to which an application is filed on or after June 8, 1995 now have a statutory life of 20 years from date of filing, query whether under current law, patent applications have become depreciable in any event.

   b. Note also that installment sale treatment will generally not be available under these circumstances. See Int. Rev. Code § 453(g), which extends the definition of "related persons" beyond that in Section 1239.

   c. For a recent private letter ruling in which the applicability of Section 1239 to the transfer of a trademark was considered, see I.R.S. Private Letter Ruling 199944045, dated August 11, 1999.

4. Similarly, property that is not a capital asset in the hands of the buyer (and that, if later sold by the buyer, will thus normally yield ordinary income) will generate ordinary income for the seller when the sale or exchange transaction involves either two partnerships controlled by the same persons, or a partnership and a partner who directly or indirectly owns more than a 50% interest in the partnership. Int. Rev. Code § 707(b)(2).

5. Finally, a U.S. taxpayer who sells a patent, copyright, secret process or formula, or similar property to a foreign corporation that the taxpayer controls will realize ordinary income rather than capital gain. Int. Rev. Code

§ 1249. Control for this purpose means the direct or indirect ownership of more than 50% of the voting stock of the entity.

C. Disallowance or Deferral of Losses and Other Deductions.

1. Because of the ability of related parties to create uneconomic tax losses or deductions, a number of tax code provisions and administrative interpretations of the law specifically preclude taxpayers from deriving a current tax benefit from a loss realized in a transaction involving a related party and place restrictions upon the ability of taxpayers to deduct amounts paid to a related party.

2. Thus, should a taxpayer sell intellectual property at a loss to a person related to the taxpayer, the loss, as such, will normally not be deductible currently. Int. Rev. Code § 267(a)(1) and, with respect to transactions involving partnerships or a partner and a partnership, Int. Rev. Code § 707(b)(1).

a. If the transferor and the transferee are members of the same controlled group of corporations, the loss will typically be deferred. Int. Rev. Code § 267(f). The regulations under this provision (Treas. Reg. § 1.267(f)-1) apply consolidated return principles. Cf. *UnionBanCal Corp. v. Commissioner*, 305 F.3d 967 (9th Cir. 2002).

b. Otherwise, the transferee may reduce his or its subsequent gain by the amount of the loss disallowed on the initial sale. Int. Rev. Code § 267(d).

3. Similarly, the provisions of Section 197 dealing with the amortization of intangibles generally will not apply to intangibles acquired by a taxpayer from a person related to the taxpayer in certain types of transactions if a depreciation or amortization deduction would not otherwise be available.

a. Transfers of know-how, for example, may be affected by this provision.

b. See the "anti-churning" rules in Int. Rev. Code § 197(f)(9); Treas. Reg. § 1.197-2(h); and I.R.S. Private Letter Ruling 9630015, dated April 26, 1996.

c. For a recent ruling dealing with the application of the anti-churning rules to partnerships, see Revenue Ruling 2004-49, 2004-21 Int. Rev. Bull. 1.

4. Moreover, if a taxpayer licenses intellectual property from a related party:

a. The royalties will not be deductible to the extent they are determined by the Internal Revenue Service to be unreasonable in amount. See Revenue Ruling 69-513, 1969-2 Cum. Bull. 29; *Podd v. Commissioner*, T.C. Memo 1998-231; *Dharma Enterprises v. Commissioner*, 194 F. 3d 1316 (9th Cir. 1999)

b. Nor will the royalties be deductible until the payee is required to include them in gross income under the so-called matching principles in Section 267(a)(2). This provision precludes an accrual method licensee from taking a tax deduction for amounts payable, but not yet paid, to a related licensor who, as a cash-method taxpayer, reports income only upon receipt. For the applicability of this provision to amounts due a foreign payee, see Treas. Reg. § 1.267(a)-3.

c. See also *Charlotte's Office Boutique, Inc. v. Commissioner*, 121 T.C. 89 (2003), indicating that a payment to a related party designated as a royalty may in fact constitute compensation subject to employment tax withholding.

5. For comparable provisions that apply to corporations filing consolidated tax returns, see Treas. Reg. § 1.1502-13, dealing with intercompany transactions.

II. **Transfers to a Controlled Corporation.**

A. Transfers to a Domestic Corporation.

1. In general, when a taxpayer transfers intellectual property to a domestic corporation that the taxpayer controls immediately after the transfer, there will be no gain or loss for tax purposes.

a. Note, however, that in 1995 the Treasury Department and the Internal Revenue Service began an informal study of the treatment of transfers of intellectual property under Section 351, and the President's fiscal year 2000 budget proposal on the subject, discussed below, may reflect the outcome of that study. See 69 *Tax Notes* 952 (Nov. 20, 1995).

b. With respect to the transfer by a tax-exempt organization of intellectual property rights to a taxable subsidiary, see I.R.S. Private Letter Ruling 9705028, dated November 5, 1996.

c. With respect to a mere nonexclusive license of a patent to a controlled corporation, see Revenue Ruling 58-260, 1958-1 Cum. Bull. 126.

2. The statutory requirements for non-recognition appear in Section 351 of the tax code. In general:

a. Property must be transferred in exchange for stock; the receipt of securities is no longer permitted. Moreover, under Section 351(g), added by the Taxpayer Relief Act of 1997, the receipt of certain preferred stock is no longer permitted on a tax-free basis.

b. The transferor must, alone or with other transferors, own immediately after the exchange stock possessing at least 80% of the corporation's voting power and at least 80% of all other classes of corporate stock.

3. Section 351 applies only to transfers of property. See generally I.R.S. Private Letter Ruling 8432073, dated May 8, 1984.

a. Patent rights have been determined to be property under Section 351. Treas. Reg. § 1.351-1(a)(2), ex. (1).

b. With respect to computer software, see Revenue Procedure 74-36, 1974-2 Cum. Bull. 491; with respect to copyrights and trademarks, see Revenue Procedure 83-59, 1983-2 Cum. Bull. 575; and with respect to trademarks alone, see I.R.S. Private Letter Ruling 9710018, dated December 5, 1996.

c. Note that the Internal Revenue Service has concluded that the right to receive license fees in the future is not property. I.R.S. Field Service Advice 200149019, dated August 31, 2001.

4. The government's characterization of know-how for purposes of Section 351 is less certain than its characterization of other forms of intellectual property.

a. Know-how is discussed in Revenue Ruling 71-564, *supra*, and Revenue Procedure 69-19, 1969-2 Cum. Bull. 301, in which the Internal Revenue Service appeared to view secrecy as an essential element of the technological information to which the provisions of Section 351 can apply.

b. The Internal Revenue Service has characterized know-how as secret where (i) it is known only to the transferor and those confidential employees who need to have knowledge of the know-how so that they

can apply it for its intended use, and (ii) adequate safeguards are taken to guard against unauthorized disclosure. See I.R.S. Private Letter Ruling 8502024, dated October 15, 1984.

c. Note also that Treas. Reg. § 1.861-18, dealing with the tax treatment of certain transfers of computer programs, states that information concerning a computer program will be treated as know-how for purposes of applying the regulation only if, among other requirements, it is furnished under conditions preventing its unauthorized disclosure and it is considered property subject to trade secret protection.

5. A transfer is also required under Section 351.

a. For rulings purposes the Service has taken a restrictive posture regarding the extent of the rights in intellectual property that must be transferred in order to satisfy the requirements for non-recognition under Section 351. The question that the Service asks is whether the transaction, if taxable, would be treated as a sale for tax purposes rather than as a mere license. See Revenue Ruling 69-156, *supra*; I.R.S. Private Letter Ruling 9810010, dated December 3, 1997. But see I.R.S. Private Letter Ruling 200217051, dated January 28, 2002, dealing with the contribution of less than all substantial rights in certain intellectual property to a corporation.

b. Thus, under Internal Revenue Service rulings guidelines, a conveyance of all substantial rights in patents and patent applications is required; all rights, title, and interests in a copyright, in each medium of exploitation, must be transferred; and, in the case of a trademark, the transferor cannot retain any significant power, right, or

continuing interest in the property. See Revenue Procedure 83-59, *supra*, and the preamble to final Treas. Reg. Sec 1.861-18 (T.D. 8785), discussing the "all substantial rights" test.

c. The courts, on the other hand, have been more liberal. See *E.I. duPont de Nemours & Co. v. United States*, *supra*, involving a non-exclusive license.

d. Note also that the Administration has in the past proposed eliminating the "all substantial rights" requirement, provided that both parties to the transaction treat it in the same manner. See *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* prepared by the staff of the Joint Committee on Taxation, at page 225. The same proposal appeared in the Administration's Fiscal Year 2001 Revenue Proposals, and legislation to the same effect has been introduced since then.

6. Notwithstanding the general rule, if the intellectual property was developed specifically for the transferee, the stock received in exchange may be regarded as taxable compensation for services rendered. See Int. Rev. Code § 351(d); Treas. Reg. § 1.351-1(a)(1)(i); Revenue Procedure 69-19, *supra*. Compare *Blum v. Commissioner*, 11 T.C. 101 (1948), with *Chilton v. Commissioner*, 40 T.C. 552 (1963).

7. However, ancillary services rendered by a transferor incident to the transfer of property will typically be disregarded, so that no portion of the stock received by the transferor will be viewed as taxable compensation income. See Revenue Ruling 64-56, 1964-1 Cum. Bull. 133.

8. Also, where no stock is actually issued to the transferor in exchange, the transfer of intellectual property to a corporation may instead be treated as a tax-free contribution to capital. See Int. Rev. Code §§ 118 and 362(c).

B. Transfers to a Foreign Corporation.

1. If the transferee of intellectual property is a foreign corporation, rather than a domestic corporation, the provisions of Section 351 of the tax code will not protect the U.S. transferor from taxation.

2. Under Section 367(a)(1), to which transfers of copyrights not treated as capital assets are subject (see Int. Rev. Code § 367(a)(3)(B)(i)), the U.S. transferor will realize ordinary income when the transfer occurs to the extent the transferor would have realized ordinary income had the property been sold instead. See Temporary Treas. Reg. §§ 1.367(a)-1T, 1.367(a)-5T(b)(2), and 1.367(d)-1T(b). Note that the provisions of Treas. Reg. § 1.861-18 apply for purposes of determining the impact of Section 367 upon the transfer of a computer program.

3. Section 367(d), added by the Tax Reform Act of 1984, deals with the transfer of other intangibles (including patents, know-how, trademarks, and other copyrights) to a foreign corporation in a transaction to which Section 351 would otherwise apply.

a. Overturning prior law (see Revenue Procedure 68-23, 1968-1 Cum. Bull. 821), this provision, which will apply unless regulations provide to the contrary, does not distinguish between transfers of U.S. and foreign intangibles, nor does it focus upon the nature of the business in which the intangibles are to be used. On its face, the provision applies not only to intangibles transferred to a foreign entity that will manufacture goods for the U.S. market, but also to intangibles to be

used to produce abroad a product for consumption abroad. See Temporary Treas. Reg. §§ 1.367(a)-1T(d)(5)(i) and 1.367(d)-1T(b).

b. Moreover, the Service will seek to apply this provision under certain circumstances whenever intangibles are simply licensed for a limited period of time. See Temporary Treas. Reg. § 1.367(d)-1T(g)(4)(ii).

4. Under Section 367(d), a U.S. taxpayer will be deemed to have transferred the intangibles in question in exchange for payments that are contingent on the productivity, use, or disposition of the property, and, notwithstanding the actual consideration paid, will be deemed to receive each year over the useful life of the property (or, if less, 20 years) an amount commensurate with the income attributable to the intangibles. See Temporary Treas. Reg. § 1.367(d)-1T(c)(3). The Taxpayer Relief Act of 1997 repealed the treatment of this deemed ordinary income as U.S. source income, so that the regular royalty sourcing rules will now apply. Int. Rev. Code § 367(d)(2)(C), as amended effective August 5, 1997.

a. Under the temporary regulations, however, an election to treat the transaction as a sale can be made under certain circumstances — for example, when operating intangibles (e.g., studies) are transferred or, in general, when at least half of the property that the U.S. transferor transfers consists of intangibles to be used abroad in the active conduct of a business not involving the manufacture or sale of products in the United States or for the U.S. market and the U.S. transferor receives between 40% and 60% of the transferee, a newly formed entity, at least 40% of which is owned by unrelated foreign persons. Temporary Treas. Reg. §§ 1.367(a)-1T(d)(5)(ii) and 1.367(d)-1T(g)(2).

b. Then the taxpayer will be taxed at ordinary income rates on the built-in gain, which, under the temporary regulations, will be treated as U.S. source income.

5. The extent to which trademarks are covered by Section 367(d) is not clear.

a. Section 367(d) applies to transfers of intangible property referred to in Section 936(h)(3)(B), including "any trademark, trade name, or brand name."

b. However, the General Explanation of the 1984 Act prepared by the Joint Committee on Taxation states: "The Act contemplates that, ordinarily, no gain will be recognized on the transfer of . . . marketing intangibles (such as trademarks or trade names) developed by a foreign branch to a foreign corporation."

c. On the other hand, the Conference Report on the 1984 Act states: "The conferees wish to clarify that, as under present law, gain will generally be recognized under section 367(a) on transfers of marketing intangibles (such as trademarks. . .) for use in connection with a U.S. trade or business, or in connection with goods to be manufactured, sold, or consumed in the United States." H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 955 (1984).

d. The Treasury Department appears to have resolved the ambiguity by taking the position that foreign marketing intangibles (including trademarks) developed by a foreign branch and transferred to a foreign corporation before May 16, 1986 are not subject to Section 367(d). See Temporary Treas. Reg. §§ 1.367(a)-1T(d)(5)(iv) and 1.367(d)-1T(b).

6. Although mere contributions to the capital of a domestic corporation may be tax-free, contributions to the capital of a foreign corporation will normally be taxed. See Revenue Ruling 64-155, 1964-1 (Pt. 1) Cum. Bull. 138; I.R.S. Private Letter Ruling 9343009, dated July 21, 1993. See also *Nestle Holdings v. Commissioner*, T.C. Memo 1995-441, remanded (on a different issue), 152 F.3d 83 (2d Cir. 1998), where the taxpayer sought to treat a sale as in part a capital contribution.

   a. If the 80% voting control requirement of Section 351 is met, the provisions of Section 367 will apply as though the transferor had received stock of the foreign corporation equal in value to the property transferred. See Int. Rev. Code § 367(c)(2), reversing the position taken in *Abegg v. Commissioner*, 50 T.C. 145 (1968).

   b. Otherwise, under current law, the transferor will be required to include any built-in gain in his or its U.S. gross income, as though the property had actually been sold, if so provided in regulations promulgated by the Internal Revenue Service. Int. Rev. Code § 367(f).

   c. Prior to the Taxpayer Relief Act of 1997, however, different rules applied. Built-in gain was taxable at 35% when a U.S. citizen, resident, corporation, partnership, estate, or trust contributed property to a taxable foreign corporation as paid-in surplus or as a contribution to capital. Int. Rev. Code §§ 1491 and 1492(1) and (2)(A), as in effect prior to August 5, 1997. For failure to file a return reflecting such a contribution made after August 20, 1996, a penalty equal to 35% of the gross reportable amount could have been imposed. Int. Rev. Code § 1494(c), added by the Small Business Job Protection Act of 1996. See I.R.S. Notice 96-60, 1996-2 Cum. Bull. 227; I.R.S.

Notice 97-18, 1997-1 Cum. Bull. 389; I.R.S. Notice 97-42, 1997-2 Cum. Bull. 293; and I.R.S. Notice 98-17, 1998-1 Cum. Bull. 688.

d. To avoid this excise tax under prior law, the transferor either had to elect to have principles similar to those of Section 367 applied to the transaction, or had to elect under Section 1057 (also repealed by the Taxpayer Relief Act of 1997) to include any gain in his or its U.S. gross income, as though the property had actually been sold. Int. Rev. Code § 1492. See I.R.S. Technical Advice Memorandum 9647004, dated August 2, 1996.

e. Note that the Tax Reform Act of 1984 deleted the ability of a taxpayer to avoid the former excise tax by establishing in advance that the transfer would not be in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

7. For certain reporting requirements, see Int. Rev. Code § 6038B and Treas. Reg. § 1.6038B-1, requiring in certain instances the use of Form 926, Return by Transferor of Property to a Foreign Corporation.

a. Note that the reporting requirements apply to transfers of intellectual property made by a U.S. person that are not viewed as taxable contributions to capital.

b. There are significant penalties for failure to comply – i.e., the lesser of $100,000 (absent intentional disregard of the law) or 10% of the value of the property transferred.

III. **Transfers to a Foreign Partnership**.

A. Under the law in effect prior to the Taxpayer Relief Act of 1997:

1. A U.S. citizen, resident, corporation, partnership, estate, or trust who contributed property to a foreign partnership was taxed at 35% on the built-in gain, notwithstanding the provisions of Section 721 that impose no tax when a taxpayer transfers property to a partnership in exchange for an interest in the partnership. Int. Rev. Code § 1491, as in effect prior to August 5, 1997. See I.R.S. Technical Advice Memorandum 9618003, dated January 17, 1996, and, with respect to the definition of "property," *United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984).

2. To avoid this excise tax, the transferor was able to take either of the two steps described above, available to a taxpayer who contributed to the capital of a taxable foreign corporation in a transaction that failed the 80% voting control requirement of Section 351. Int. Rev. Code § 1492, as in effect prior to August 5, 1997. See I.R.S. Technical Advice Memorandum 9704004, dated October 23, 1996; I.R.S. Private Letter Ruling 9741037, dated July 14, 1997.

B. Under current law, (i) by regulation, rules comparable to those in Section 367(d) may apply, or (ii) immediate gain recognition will be required to the extent provided in regulations promulgated by the Internal Revenue Service if gain would otherwise be recognized later by a non-U.S. person.

1. See Int. Rev. Code §§ 721(c) and (d) and 367(d)(3), added by the Taxpayer Relief Act of 1997.

2. Note that it is not yet clear whether immediate gain recognition will be required with respect to transfers of property to domestic as well as foreign partnerships. It appears, however, that the statute as worded gives the government the authority to do so.

C. In addition, the reporting requirements under Section 6038B have been extended to cover certain transfers made by U.S. persons to foreign partnerships, effective with respect to transfers made after August 5, 1997. Reporting will be required if the transferor holds at least a 10% interest in the partnership after the transfer, or if the transferred property and any other property transferred to the same partnership by the same person or a related person within the 12-month period ending on the date of the most recent transfer is worth more than $100,000.

1. For simplified reporting rules applicable to transfers made before January 1, 1998, see I.R.S. Notice 98-17, *supra.*

2. With respect to transfers made on or after January 1, 1998, see Treas. Reg. § 1.6038B-2, directing that reportable transfers of property to foreign partnerships be reported on Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.

3. The penalties for noncompliance are substantial. First, there is a monetary penalty equal to the lesser of $100,000 (absent intentional disregard of the law) or 10% of the value of the property transferred. Secondly, the transferor will be required to include in gross income any unrealized gain inherent in the property.