From Brain to Balance Sheet: Tax Considerations

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Excerpt from *Entrepreneurs' Guide to Patents, Trademarks, Copyrights Licensing and Trade Secrets* (Penuguin/Putnam Press 2004)

Albert Einstein once said that "the hardest thing in the world to understand is income tax." Fortunately, most successful innovators can hire accountants.

In This Chapter You Find Out:

- The advantages of expensing intellectual property rather than amortizing it
- When intellectual property can qualify for favorable capital gains tax rates
- How disclosure can jeopardize trade secret deductions

> ***DuPont Paint Company maintains that certain paint formulas are trade secrets. DuPont takes the position that the trade secrets are a form of intellectual property, and consequently, the company should be permitted to take amortization deductions for the asset. However, the IRS denies these deductions. Dupont appeals, and the court upholds the IRS determination, based on the fact that DuPont failed to maintain secrecy, and therefore the formulas can't be treated as trade secret assets. Since there is no asset, there can be no deduction.***[1]

[1] *DuPont vs. U.S.*, 288 F.2d 904 (Ct. Cl. 1961).

The intellectual property area is replete with unexpected tax consequences. However, careful planning can control many results and turn the tax situation to your advantage.

Some Core Tax Planning Concepts

The biggest single expense individuals and businesses usually incur is taxes. If intellectual property -- patents, trademarks, copyrights and trade secrets -- are significant line items on your balance sheet, you can benefit from understanding how the I.R.S. views and treats them. Tax planning for these "intangibles" involves both careful drafting of agreements for transactions involving them, and correct treatment and classification of the assets and transactions.

You and your accountant may routinely discuss the documents and details of your tax situation. But it helps to have a broader sense of how the Internal Revenue Code works and what tax planning goals you are working toward. Some core concepts of tax planning are summarized in this Section.

Defer Income, Accelerate Deductions

An almost universal tax planning objective is paying later rather than sooner. Money that you can legitimately hold onto at tax time can be put to good use in your business, or invested for a profit until it comes due.

Deferring income means recognizing it in the latest tax year possible. This may mean waiting to sell an asset until after the close of the tax year, or taking other actions that cause the income to be taxed to you in a subsequent year. On the other hand, when it comes to deductions, you want to take them as soon as you can, keeping the current tax bill as low as possible. This gives you more cash to invest in developing and marketing your idea.

Useful Assets Decline in Value Over Time

Amortization is a concept similar to depreciation, except that it applies to intangible assets, such as intellectual property. Intangible assets are *amortized* over their useful life. An amortization deduction can be taken each year over the useful life of the asset.

Expensing Is Usually Better Than Amortizing

If you have a choice between taking the entire cost of an asset as an expense deduction in the year that you buy it, or amortizing it over its useful life, which would you choose? Expensing the whole thing the first year is usually preferable, since you're accelerating the amount of your present deduction.[2]

However, there are some situations where it may be in your interest to amortize, if you're permitted to elect to do so. For example, suppose you have some research that can be deducted currently. Your accountant may advise you elect to amortize these costs

[2] Research and experimental expenditures may be deducted currently, rather than capitalized under section 174(a) of the Internal Revenue Code. Computer software development expenses are considered research and experimental expenses. Trademark development costs are not, and must be amortized over a 15-year period under section 197. See section 197(e)(3) (excluding software developed in-house from "section 197 intangibles"), and 197(d)(1)(f) (including trademarks).

over a period of 10 years, if you own all the shares in a certain type of small business corporation known as an S corporation.

If the S corporation takes the deduction on its corporate income tax return, the deduction is "passed through" to your individual income tax return. Those particular expenses (not just the deductions) might have to be added back to your income for purposes of computing your alternative minimum tax (if you're subject to it). The amount added back could increase your personal income tax, wiping out the benefit of the deduction on the corporate return. However, if you elect to amortize the expenses over 10 years, there's no add back on your personal return.

Capital Gains Rates are Lower Than Ordinary Income Tax Rates

Assets held "for investment" like equipment, trucks stocks, bonds and real estate (as opposed to inventory or supplies) are considered capital assets. Intellectual property, such as patents, trademarks copyrights and trade secrets are all forms of capital assets.

When you sell a capital asset for a profit, that profit is taxed at the prevailing capital gains tax rate, as opposed the income rate charged on other "ordinary income" your business may earn. (You don't have to pay tax on a capital gain until you sell the asset.)

Capital assets can be either *long term* or *short term*. Long-term capital assets are assets held for more than one year. Long term capital gains tax rates are generally lower, favorable rates, reflecting a national policy of encouraging Americans to invest in the

nation's businesses for the long haul. Short-term capital gains are taxed at ordinary income rates.

If you hold a capital asset for at least a year and a day before you sell it, you're entitled to the special capital gain rate. In most cases, this rate will be 20% (10% if your total taxable income falls within the 15% bracket). There are exceptions for certain types of assets.

IRS Classifications of Intellectual Property Transactions

Transactions involving the sale and licensing of intellectual property rights can erupt in a volcano of tax consequences. How they are treated by the I.R.S. depends on a variety of factors, including (but by no means limited to) the following:

- Is transaction is deemed a sale, or a license or lease transaction?
- Are you the original creator of the property, or did you purchase it from someone else?
- Is the property a "capital asset?"

This section looks at how these considerations apply to specific types of intellectual property.

Patent Licenses

Suppose your company enters into an agreement to license a patent it owns to someone else. The agreement entitles the licensee to make and sell a patented product for ten years. Even though the agreement between you and the licensee may be specifically titled "License," the transaction may be deemed a sale by the IRS.

The IRS uses pre-established criteria from the Internal Revenue Code to determine whether the transaction is a sale. The IRS' main concern is whether the patent owner is essentially transferring all useful interest in the patent, and whether the patent rights will have any value that reverts to the patent owner at the end of the license agreement. The IRS will give considerable weight to the issue of whether license rights were acquired in connection with the acquisition of a substantial part of a trade or business, which makes it more likely that the transaction will be treated as a sale.

If the IRS concludes the transaction is a sale, the Internal Revenue Code requires you to amortize the acquisition costs ratably over 15 years or to depreciate the cost over the remaining useful life of the patent. This is less advantageous than taking larger lease expense deductions over the 10 year period of the agreement.[3]

On the other hand, if the IRS determines the license agreement is truly a license transaction, the tax treatment is more favorable. Payments under the agreement can be deducted in full as they are actually incurred.

One factor that weighs heavily in favor of treating the transaction as a license is whether the license is non-exclusive. In other words, whether the licensee receives less than an exclusive right to use the patent. Non-exclusivity indicates that the patent holder has retained some significant rights and the transaction looks a lot less like a sale for tax purposes.

[3] Internal Revenue Code Sections 197(e)(4); 167(f)(2).

Trademarks

Trademark licenses are a little trickier, and may also be deemed sales subject to amortization rules. In the case of a trademark license, the IRS permits you to deduct your payments as you make them (instead of amortizing) only if the payments are (a) contingent on the productivity, use or disposition of the mark, (b) payable at least annually, and (c) substantially equal in amount or payable under a fixed formula. Otherwise, the IRS requires you to amortize the trademark license payments over a 15-year period.[4]

Trade Secrets

Trade secrets, if you can prove they exist, are an asset, like other types intellectual property.[5] The IRS takes the position that if the information hasn't been kept confidential, it doesn't rise to the level of trade secret and thus can't be an asset.[6] Sales of trade secrets are usually treated as capital gains transactions.

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[4] Internal Revenue Code Sections 1253(d)(1) and 2.

[5] Internal Revenue Code Section 197.

[6] The language of section Internal Revenue Code Section 197 specifically includes business information and know-how as a "section 197 intangible." This language is often the basis for taxpayers challenging the IRS position in the courts.

Copyrights

A copyright that you use in your trade or business can be the source of some welcome tax deductions. Copyright development costs are generally deductible over the useful life of the copyright.[7]

Sales of copyrights can result in taxable gain. Unfortunately, such sales by the person who created the work can *never* qualify for capital gains treatment.[8] However, copyrights you've purchased from some other person or entity can be resold as capital assets.

Warning! Consult a Tax Professional

Taxation can be a tumultuous area, with changes in the law that catch you be surprise from year to year, or even month to month. Incorrect treatment of a transaction can result in assessments of interest and penalties. Unless you plan on devoting a substantial amount of your intellectual energies to staying current in this area, you should consult an accountant or attorney versed in intellectual property taxation prior to entering into any of the types of transactions discussed or described in this Chapter.

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[7] Treas. Reg. section 1.167(a)-6(a).

[8] Internal Revenue Code Section. [8] Section 1221(3).