ORANGE COUNTY

LAWYER

Young Lawyers Division
Bar Passage and Beyond

Plus:
DC Comics and Copyrights
Beware the Accidental Franchise
Distinguishing "Privileged" From "Confidential"

www.ocbar.org AN OFFICIAL PUBLICATION OF THE ORANGE COUNTY BAR ASSOCIATION July 2013 Vol. 55 No.7 $4.00

Taxation of Patents and Patent Rights

by J.F. KARCH

Patents and taxes are both complex areas of the law. Put them together and the potential for confusion is compounded. To provide a framework of understanding, this article provides an introduction to some applications of tax laws to patents.

Patents are a species of intellectual property which are treated for tax purposes by a myriad of various rules and regulations, which even highly experienced tax practitioners have difficulty navigating, and which are also archaic with respect to current advancements in technology and intellectual property applications. This article discusses the tax treatment issues of various aspects of patents as "property," and the tax consequences of sale or licensing of various "rights" associated with a patent.

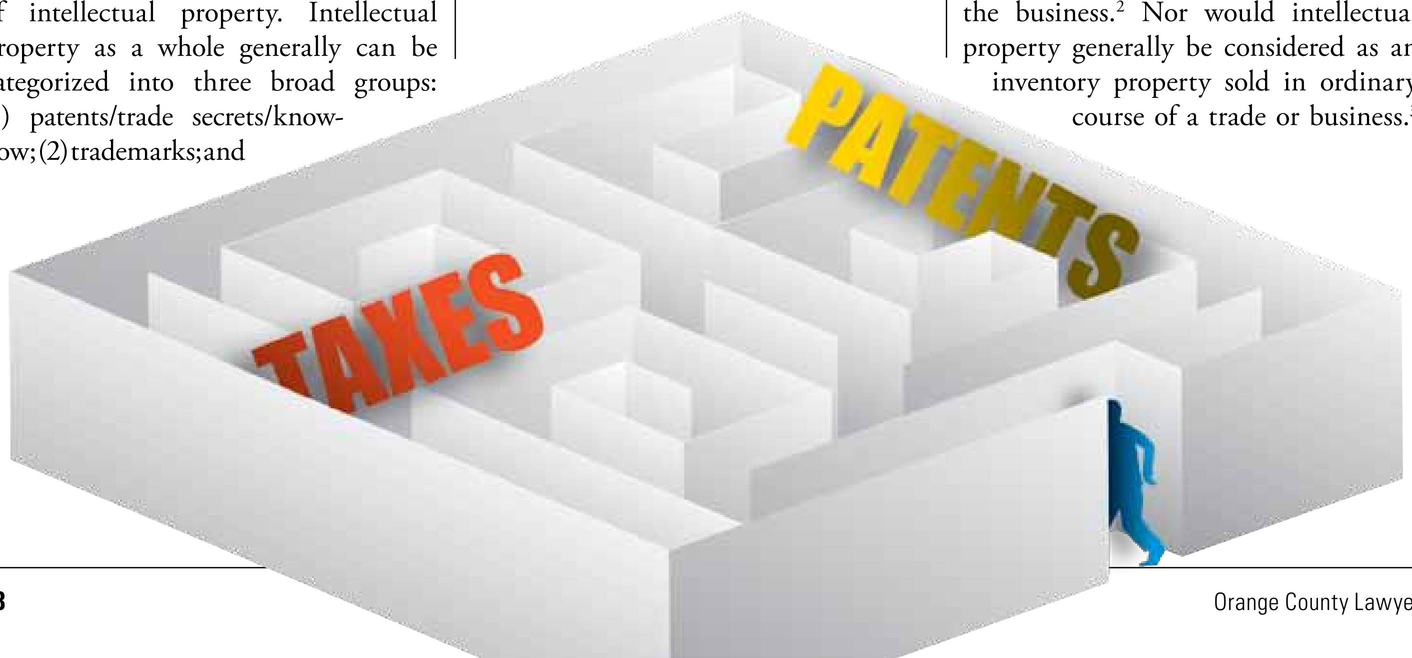
What Is a Patent?

Let's begin by separating out patents from the general assortment of intellectual property. Intellectual property as a whole generally can be categorized into three broad groups: (1) patents/trade secrets/know-how; (2) trademarks; and (3) copyrights. A patent is a set of exclusive rights granted by the government to an inventor. It is a limited property right, usually for twenty years, that the government gives inventors in exchange for public disclosure of the invention. A patent is not a right to practice or use the invention. Instead, a patent grants the right to *exclude others* from making, using, selling, or offering for sale the patented invention. The owner of a patent is granted the legal right to exclude the unauthorized use, manufacture, sale, offer of sale, or importation of products/services that include the patented article.

There are two basic kinds of patents. *Utility* patents are grants to inventors for new, useful, and unobvious processes, machines, and compositions of matter. *Design* patents are for new, ornamental, and unobvious designs of manufactured articles. For our purposes, patents will include exterior design of an article; plant varieties; and utility patents for inventions relating to mechanisms, processes, or compositions of materials (sometimes overlapping with copyright as in the case of some software). Patents are uniformly examined and registered through the U.S. Patent and Trademark Office, an agency of the U.S. Department of Commerce, located in Alexandria, Virginia and in the process of opening various satellite offices beginning with Detroit in 2012. The agency coordinates and cooperates with the European and Japanese Patent Offices. Accepted patent applications are recorded for an initial term of twenty years.

Tax Considerations for Patents

Generally there are "intangible" attributes associated with intellectual property. Intellectual property, a creature established by statute, is not usually considered tangible assets, or "capital assets," which are generally depreciable for its use in a trade or business, or investment,[1] and subject to "recapture" (taxed as income) on sale of the asset if too fast a depreciation (more expense) had been taken for the asset's use in the business.[2] Nor would intellectual property generally be considered as an inventory property sold in ordinary course of a trade or business.[3]



Such properties are subject to their own unique tax regimes.

Patents are subject to their own statutory tax regimes, primarily relating to deductions of research and development costs,[4] sale or exchange of the patent,[5] or royalty income from licensing or assignment of patent rights pertaining.[6] Internal Revenue Code (I.R.C.) § 1235 provides significant advantage to a patent "holder" by taxing the sale or transfer of the patent (which means "all substantial rights" in the patent) as a capital gain (at a current 20% maximum federal rate, as opposed to ordinary income at a current 39.6% maximum federal rate), regardless of whether it was held less than one year (which would normally require "short term capital gain" tax at ordinary income rates), and without being subject to any recapture for any deductions already taken against the patent (which would normally have reduced the cost basis of the asset sold and created more taxable gain).

Red Flags to Consider

There are a couple red flags of which to be wary. First, the "holder" must be an individual owner creating the patent, not an entity. Second, any retained "rights" relating to the patent are subject to strict scrutiny. Some latitude is afforded to a particular individual "holder" who may have "bought into" the patent prior to its being "reduced to practice." However, there is little latitude for the holder retaining any rights (other than as a secured creditor in the sale of the patent), which might in any way limit the patent purchaser's licensing or assignment, geographical restrictions, fields of use, termination of use, and so forth.

Otherwise, of course, the IRS would vastly prefer to characterize any objectionable "sale or transfer" instead as a "licensing or assignment" of particular patent rights, and assess the much higher ordinary income taxes against the royalties thereby deemed received on account. Any gains, allowable deductions, or such income would be regularly reported as required by annual federal and state returns by individuals (resident, non-resident, or foreign as applicable) or by entity pertaining.

On the other hand, the purchaser of a patent (presuming such purchaser had not specifically retained the "holder" to create the patent as a work for hire to be used in the purchaser's business), would seek to structure its I.R.C. § 212 trade or business using the acquired patent under I.R.C. § 174, which permits alternatively (1) expensing costs of the patent within the allowed statutory limitations;

For individuals and companies seeking to license, buy, or apply for patents in foreign countries, it pays to have detailed knowledge of the domestic tax system of the country being targeted.

(2) amortizing the costs over sixty months; and/or (3) depreciating the patent under I.R.C. § 167. Alternatively, the purchaser would apparently be left only with having to amortize the patent over fifteen years under I.R.C. § 197.

Most countries have their own tax regimes, which may be just as complex as those in the United States. For individuals and companies seeking to license, buy, or apply for patents in foreign countries, it pays to have detailed knowledge of the domestic tax system of the country being targeted. China's tax regulations, for example, are largely enacted on the municipal level rather than being dictated by the federal government. It is important to remember that the tax considerations outlined in this article apply exclusively to United States patent holders operating in the United States who are therefore subject to IRS rules and regulations.

When grappling with the tax implications of a patent portfolio, it is important to consult business and legal advisors who are well versed in the nuances of patent law and the tax code as it applies to intellectual property. Where patents are invaluable, particularly where owned by companies, understanding and making strategic decisions based on the tax implications of the intellectual property holdings should become a regular part of the business plan.

ENDNOTES

(1) Internal Revenue Code (I.R.C.) § 1221.
(2) I.R.C. § 179.
(3) I.R.C. § 1231.
(4) I.R.C. § 174.
(5) I.R.C. § 1235.
(6) I.R.C. § 61.

J.F. Karch *is a Partner at WHGC, P.L.C. and provides counsel on the fundamental tax considerations discussed in this article. In addition to tax treatments, Mr. Karch also assists clients with a variety of corporate transactions matters related to foreign investment, commercial and residential real estate, estate planning, asset protection, mergers and acquisition, and securities law. He can be reached at RickKarch@WHGCLaw.com.*

This article first appeared in Orange County Lawyer, *July 2013 (Vol. 55 No. 7), p. 28. The views expressed herein are those of the Author. They do not necessarily represent the views of* Orange County Lawyer *magazine, the Orange County Bar Association, the Orange County Bar Association Charitable Fund, or their staffs, contributors, or advertisers. All legal and other issues must be independently researched.*