PART XVIII: INTELLECTUAL PROPERTY

8003. What are the most critical tax issues involving companies that own, acquire, sell, and/or create intellectual property?

In many instances, a company's most valuable asset is its portfolio of intellectual property. Intellectual property assets include patents, trademarks, trade secrets, formulas, domain names, software, etc. Many tax and business issues must be analyzed to determine who should own the intellectual property (holding company, etc.) and where (what country or state). The tax issues involving intellectual property are extremely complex. While many issues impact the taxation of intellectual property, five of the primary tax issues that a tax advisor must be familiar with when dealing with intellectual property are:

1. *The most tax effective way to utilize the costs incurred in developing or creating the intellectual property*. While a current deduction may be most advantageous, in many instances that option is not available. The IRC Sections that may apply include Sections 162, 174, 263, and 263A. Note that certain Sections as well as state laws may impact the deductibility of certain costs paid to a related party.

2. *Existing tax credits for the research and development expenses incurred by the business*. The Internal Revenue Code Sections that may apply in this area include Sections 38 and 41, as well as state-level credits.

3. *How to treat the costs incurred when acquiring or selling intellectual property*. The primary Internal Revenue Code Sections to consider in making this determination include Sections 167, 197, 263, 267, 1001, 1231, 1235, 1239, as well as other common Sections applicable to the sale or exchange of an asset.

4. *The character of income received from a licensing arrangement*.

5. *The character of income received from the outright sale of intellectual property*.

8004. When are the costs incurred in creating intellectual property currently deductible?

Many businesses own intellectual property, including patents, trademarks, copyrights, as well as computer software. Businesses incur significant costs to acquire, create, or maintain their intellectual property assets. A primary issue facing businesses is whether the costs can be deducted when incurred, over time, or considered a capital expenditure. While deductions are a "matter of legislative grace," certain costs incurred in the creation of intellectual property may be currently deductible under IRC Sections 162 or 174. Section 162 allows a current deduction for all ordinary and necessary expenses paid or incurred during the current taxable year in carrying on a trade or business. To satisfy the "carrying on a trade or business" requirement imposed by Section 162, the taxpayer may need to demonstrate that the expense was not incurred while pursuing a hobby, but instead, in a regular and on-going business venture. The taxpayer does not have to show profits to prove the existence of a "trade or business."

Section 174 allows a taxpayer to treat research and development expenses incurred or paid during the current year for developing intellectual property in connection with a trade or business as deductible expenses which are not chargeable to a capital account. Thus, the costs would be deductible in the current year. In the alternative, Section 174(b) provides taxpayers the option of deducting the expenses ratably over no less than sixty months. Under this option, the costs are referred to as "deferred expenses." To deduct the deferred expenses, the taxpayer must make the election no later than the time for filing the taxpayer's return, including extensions.[1] As Congress enacted Section 174 to encourage taxpayers to invent new IP, certain early stage expenses may be deductible under Section 174 even though the same expense would not be deductible under Section 162.[2]

8005. What are the requirements for the IRC Section 41 credit for increasing research activities?

IRC Section 38 allows a current year business credit against income tax imposed for the amount of a research credit determined under Section 41. Under Section 39, a taxpayer may carry back the credit for one year and carry forward for twenty years.

The research credit is an amount equal to the sum of:

(1) 20 percent of the excess (if any) of—

(A) the "qualified research expenses" for the taxable year, over

(B) the "base amount;"

(2) 20 percent of the "basic research payments;" and

(3) 20 percent of the amounts paid or incurred in carrying on a trade or business to an energy research consortium for energy research.

Generally, qualified research expenses include in-house research expenses and contract research expenses.[3] Qualified research is defined as research (1) with respect to which expenditures may be treated as expenses under Section 174, (2) which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and (3) substantially all of the activities of which constitute elements of a process of experimentation for a purpose that relates to a new or improved function, performance, reliability or quality.

In general, for tax years beginning after December 31, 1989, the base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the preceding four years. [4] A taxpayer's fixed-base percentage is the percentage determined by taking the taxpayer's aggregate qualified research expenses for taxable years beginning after

1. IRC Sec. 174(b)(2).
2. *Snow v. Commissioner*, 416 U.S. 500 (1974).
3. IRC Sec. 41(b).
4. See IRC Sec. 41(c)(1).

December 31, 1983, and before January 1, 1989, over aggregate gross receipts of the taxpayer for the same such taxable years.[1] In no event may the fixed-base percentage exceed 16 percent.[2] Thus, for the tax years when expenditures are flat, such expenditures may be currently deductible, but not subject to the Section 41 credit.

8006. How do the capitalization rules of IRC Section 263A apply to work performed by authors, photographers, and artists?

Section 263A contains the "uniform capitalization rules," and generally provides that the direct and indirect costs of producing tangible personal property must be capitalized rather than expensed in the current tax year. For purposes of determining whether a taxpayer producing intellectual or creative property is subject to Section 263A, the Regulations provide that "tangible personal property" includes films, sound recordings, video tapes, books, and other "similar property."The similar property embodies words, ideas, concepts, images, or sounds by the creator.[3] For example, the costs of producing and developing books that are required to be capitalized include costs incurred by an author in researching, preparing, and writing the book.[4]

Planning Point: Certain ordinary business expenses are generally currently deductible and not subject to the capitalization rules. These include marketing, selling, advertising, and distribution. These expenses should be separately itemized in invoices and for contracts to demonstrate their current deductibility.

A critical exemption from the capitalization rules exists for individuals engaged in a trade or business of being a writer, photographer, or artist. Under Section 263A(h), "qualified creative expenses" are not required to be capitalized, and may be currently deductible. A "qualified creative expense" includes expenses paid or incurred by an individual in the trade or business of being a writer, photographer, or artist, which would otherwise be allowable as a deduction but for Section 263A.[5] Qualified creative expense does not include any expense relating to printing, photographic plates, motion picture films, video tapes or "similar items."

8007. How are costs treated for intellectual property that is acquired by a taxpayer rather than created?

Generally the acquisition of an intangible asset which is held in connection with the conduct of a trade or business must be amortized under IRC Section 197. Section 197 does not apply to self-created intangibles. While most consider "goodwill" as the primary intangible asset subject to Section 197, other intangible assets subject to Section 197 include property that has value but cannot be touched, such as any patent, copyright, formula, process, design, pattern, know how, format, franchise, trademark, or trade name.

Section 197 entitles taxpayers to an amortization deduction with respect to these intangibles. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of

1. IRC Sec. 41(c)(3)(A).
2. IRC Sec. 41(c)(3)(C).
3. Treas. Reg. §1.263A-2(a)(2)(ii).
4. Treas. Reg. §1.263A-2(a)(2)(A)(1).
5. IRC Sec. 263A(h)(2).

determining gain) of such intangible ratably over the fifteen-year period beginning with the month in which such intangible was acquired.

Computer software is a Section 197 intangible asset if acquired in connection with the conduct of a trade or business. However, computer software is excluded from Section 197 (and therefore may be depreciated), even if acquired in connection with the acquisition of a business, if it:

- Is readily available for purchase by the general public.
- Is subject to a nonexclusive license.
- Has not been substantially modified.

Computer software not subject to Section 197 may qualify for the Section 179 deduction and special depreciation allowances.

Other costs associated with purchasing intellectual property may not be currently deductible and instead subject to capitalization rules under Section 263.

8008. What is the character of income received from the licensing of intellectual property?

Under the central "gross income" statute, IRC Section 61, gross income received from the licensing of intellectual property, versus the sale of intellectual property, is treated as a royalty and characterized as ordinary income. The licensee may be entitled to a deduction for the royalty payments, and the licensor entitled to all the tax attributes that come with ownership of the asset.

Planning Point: Due to the difference in tax rates, the IRS may challenge those situations where a licensing arrangement is disguised as an outright sale of the intellectual property.[1]

8009. What is the character of income received from the sale of intellectual property?

If the payment is made pursuant to a sale of intellectual property, the seller should be entitled to capital gains treatment. The principal inquiry is whether the "sale" can be classified as a sale of the asset or a license. As for patents, Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a long-term capital asset regardless of whether the payments are: (i) payable periodically over a period generally coterminous with the transferee's use of the patent, or (ii) contingent on the productivity, use, or disposition of the property transferred. Section 1235 excludes employers and relatives of the creator from the definition of holders and instead gives capital gain treatment to "any individual whose efforts created" the patent or certain individuals who acquired an interest in the patent for consideration during the early stages.

1. *Watson v. Commissioner*, 222 F.2d 689 (10th Cir. 1955).