IP LAW360

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Don’t License What You Want to Sell

Monday, Jun 25, 2007 --- There are several immutable truths which, if followed, allow you to live a life without regret. For example, “Don’t forget your spouse’s name when making introductions to an old college romantic interest.”

Oftentimes these truths will reveal themselves only after they’ve been experienced—and by then, of course, it’s too late. However, if you’re lucky, you will stumble across the lesson without having to live through it.

The purpose of this article is to introduce you to one of those truths without having to go through the agonizing pain of experiencing it firsthand. Specifically, when it comes to patents, “Don’t license what you want to sell.”

* General *

For federal income tax purposes, the transfer of a patent constitutes either a sale or a license. As a sale, gain can be taxed at the preferential long-term capital gain rate of 15%.

As a license, all amounts are generally treated as royalty income, taxed at a maximum rate of 35%. A trap for the unwary is that an improperly structured sale can later be recharacterized by the IRS as a license—resulting in a much larger tax liability for the transferor than what was anticipated.

* Patents and Know How *

Code §1235 provides that a transfer by a holder of all substantial rights to a patent is treated as a sale. In such a case, gain from the sale is taxed as a long-term capital gain. However, a transfer by a holder of less than all substantial rights associated with a patent is not treated as a sale, but is instead treated as a license.

In such a case, all amounts received with respect to the license will generally be treated as royalty payments, taxed as ordinary income. To qualify for long-term capital gain treatment, the transferor must be the holder of, and transfer all substantial rights to, the patent.

a) Patent

For these purposes, the term patent generally means a patent granted under the provisions of title 35 of the United States Code. It is not necessary that the patent or patent application for the invention be in existence if the requirements of Code §1235 are otherwise met.

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b) Holder

The word holder is a defined term and means much more than the patent owner or transferor. The policy underlying Code §1235 is to encourage scientific work that leads to patentable technology. As a result, a holder is an individual whose efforts created the property—think of the “first and original” inventors.

As such, the benefits of Code §1235 are available only for developed, as opposed to acquired or assigned, patents. Thus, for example, the organization that employs an inventor cannot qualify as a holder because the individual employee’s efforts created the technology, not the employer-organization.

In a partnership, if an individual partner’s efforts create the patented invention with the understanding that the resulting patent would become partnership property, then each individual partner may qualify as a holder with respect to his or her share of the patent owned by the partnership. This rule does not apply to corporations or to corporate partners.

c) All Substantial Rights

In general, all substantial rights means all rights that have value at the time of the transfer, including all rights to exclude others from making, using, selling or importing the patented invention. If the transfer is limited, then it may be characterized as a license, and the amounts received as ordinary income. Examples of limitations that can cause a transfer to be characterized as a license include:

Geographical (i.e., limiting the transferee’s use to certain States);

Fields of use (i.e., limiting the transferee’s use to within certain trades or industries); or

Durational (i.e., limiting the transferee’s use to less than the patent’s remaining life).

Importantly, the facts and circumstances of the entire transaction (rather than the particular terminology used in the transfer documents) are considered in determining whether all substantial rights were transferred.

If certain requirements are satisfied, the rules applying to patents can also apply to know-how, such as secret formulas and trade names. A different set of rules applies to the transfer of acquired (as opposed to developed) patents or know-how.

* Practical Suggestions *

In a transaction involving patents or intellectual property, patent owners and

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IP attorneys should seek advice from tax counsel who continuously monitor tax developments in the IP industry. The following will serve as the beginning of any tax analysis.

First, confirm that the transferor qualifies as a holder. For an individual acting on his or her own behalf, this seems simple enough. If the individual whose efforts will create a patented invention intends to use an entity to pursue a business venture, then strong consideration should be given to the type of entity to be used.

A detailed discussion of the competing tax and non-tax benefits between C corporations, S corporations, limited liability companies, and partnerships is beyond the scope of this article. However, with respect to qualifying as a patent holder, it appears that a partnership or LLC taxed as a partnership is generally preferable over the corporate alternatives.

Second, identify the transferor's business objectives, as well as the tax and non-tax issues associated with the proposed transfer. Although a sale may generate tax savings, a license may be more consistent with the transferor's long-term goals.

Similarly, imposing a limitation on the transferee or retaining certain rights associated with the patent may make good business sense, but inadvertently may cause an intended sale to be recharacterized as a license. More often than not, there are legitimate business reasons competing with the requirements for sale treatment.

Care must be exercised in accomplishing a sale of a patent for income tax purposes in light of the adverse tax consequences that can arise if the transaction were characterized as a license.

Those familiar with Code §1235 know this to be true. Better you learn that lesson now than having to go through the agonizing pain of experiencing it first hand in an IRS audit.

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