Tax Considerations
For Licensors, Licensees, and
Other Parties to Intellectual
Property Transactions

PATRICIA ANN METZER

Patricia Ann Metzer is with Vacovec, Mayotte & Singer LLP in Newton, Massachusetts.

GENERAL

Goals

From a tax perspective, businesses and individual taxpayers who seek to license their intellectual property want to secure the most favorable federal income tax results. Ideally, the consideration received by a licensor will be taxed at the lowest possible rates or not at all, while the consideration paid by a licensee will be deductible in full on a current basis. Also, ideally, a transferor will not have “phantom” income, resulting in more receipts subject to tax than anticipated. Finally, in an ideal world, if any party to a transaction lives or transacts business abroad, no adverse tax consequences will thereby arise.

Variables

The actual federal income tax consequences of a license of intellectual property depend on a number of variables.1

Kind of Property. First, it is important to know the kind of intellectual property involved—that is, its character for tax purposes. For example:

- Is it a patent, a copyright, know-how, computer software, or a trademark?
- In the hands of the licensor, is it a capital asset or inventory-type property?
- In the hands of the licensee, is the property depreciable?

Nature of the Transaction. Second, a taxpayer who licenses intellectual property must determine the nature of the transaction. Specifically:

- Does the licensor retain a substantial interest in the intellectual property?
- Is the licensee of the intellectual property related to the licensor?
- Does the transaction involve a payment of compensation for services rendered?

Nature of the Consideration. Finally, the tax consequences of the transaction often will depend on the nature of the consideration received. For example:

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1. See in this regard the discussion paper released by the Treasury Department on Nov 21, 1996, “Selected Tax Policy Implications of Global Electronic Commerce.”
• Is the consideration to be paid in a lump sum or in installments?
• Are payments contingent on productivity or sales?
• Is an arm’s-length amount to be paid for the intellectual property?
• Are the payments sourced in the United States or abroad?

This article considers the tax issues faced by licensors and licensees of intellectual property, as well as those faced by joint ventures seeking to acquire intellectual property by exclusive license or assignment.

THE LICENSOR’S PERSPECTIVE

Overview
In most cases, the amount paid to a licensor of intellectual property will be subject to federal income taxation. In limited circumstances, taxation may be avoidable through the use of cross-licenses of property.

Nature of Income
Assuming a transaction is taxable from the point of view of the licensor, the nature of the income realized may be critical. If the recipient of the income is a nonresident 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. Also, the characterization of a stream of payments may be important for foreign tax credit purposes.

The basic distinction between ordinary income and capital gain and the significance of the distinction between royalty income and capital gain under other circumstances are discussed below.

Ordinary Income or Capital Gain. A distinction is drawn in the Internal Revenue Code (Code) between ordinary income and capital gain. For individual taxpayers, this distinction is important because, at present, there is a significant rate differential—that is, long-term capital gains are typically taxed at 20 percent, while the top marginal rate on ordinary income will still be higher when the rate reductions under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) take full effect. In 2006, the top marginal rate on ordinary income will fall from the pre-enactment rate of 39.6 percent to 35 percent.

The rate differential will affect not only sole proprietors and individual investors but also businesses that have chosen to operate as partnerships or S corporations or as limited liability companies treated as partnerships for tax purposes. The income of these entities will flow directly through to their owners and be includable on these owners’ own income tax returns. Many of these owners will be individual taxpayers.

So-called C corporations do not benefit at present from any lower rate on capital gains, but the distinction between capital gain and ordinary income remains important for them as well because capital losses can offset only capital gains.

Royalty Income or Capital Gain. Similarly, under certain Code provisions, royalty income, in contrast to capital gain, is in effect tainted or conversely afforded favorable treatment.

Personal Holding Companies. For example, the consideration received may cause a corporation to be treated as a so-called personal holding company that is required to

4. See IRC §§ 1201, 1211.
pay an additional tax on its undistributed personal holding company income. The tax is imposed at the highest marginal individual income tax rate.\(^5\)

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.\(^6\) Personal holding company income does not include copyright royalties that constitute at least 50 percent of a corporation’s ordinary gross income, however, provided that the royalties do not derive from works created in whole or in part by any shareholder of the corporation and that certain other statutory conditions regarding the makeup of the corporation’s business deductions and non-copyright royalty income are met.\(^7\)

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, also have been excluded from personal holding company income.\(^8\) To qualify for this exclusion, the computer software royalties must constitute at least 50 percent of the corporation’s ordinary gross income, and the corporation must meet a number of other statutory requirements relating to the dividends paid by the entity and the nature of its tax deductions.\(^9\)

**S Corporations.** An S corporation, more than 25 percent 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.\(^10\) 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 percent of its gross receipts from passive investment income during the same year may be required to pay a tax, notwithstanding the fact that S corporations generally are not subject to federal income taxation.\(^11\)

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.\(^12\) Passive investment income, however, includes neither (1) 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 (2) copyright royalties and active business computer software royalties that are not treated as personal holding company income.\(^13\)

**Passive Activity Losses.** An individual or a closely held corporation to which the passive activity loss provisions apply may be adversely affected if income is characterized as a royalty.

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\(^5\) IRC § 541, as amended by EGTRRA. See Tomerlin Trust, Transferee v Commr, 87 TC 876 (1986).
\(^6\) IRC § 543(a)(1); Treas Reg § 1.543-1(b)(3). See Rev Rul 75-202, 1975-1 CB 170; Ltr Rul 8450025 (Sept 7, 1984).
\(^7\) IRC § 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.
\(^8\) IRC § 543(a)(1)(C), (d).
\(^9\) IRC § 543(d).
\(^10\) IRC § 1362(d)(3).
\(^11\) IRC § 1375.
\(^12\) IRC § 1362(d)(3)(C)(i); Treas Reg § 1.1362-2(c)(5)(ii)(A)(1).
\(^13\) Treas Reg § 1.1362-2(c)(5)(ii)(A)(2), (3). To determine whether there are active business computer software royalties, however, the dividend requirement does not apply.
\(^14\) IRC § 469.
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.\textsuperscript{15} 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) generally will not be treated as passive income and hence cannot be offset by passive losses.\textsuperscript{16} Note that under the passive activity provisions, a trade or business includes any activity involving research or experimentation.\textsuperscript{17}

**Foreign Corporations.** The nature of the consideration received by a foreign corporation with U.S. shareholders may determine whether these shareholders will be taxable currently on all or some portion of the corporation’s net income. A U.S. shareholder of a foreign personal holding company (FPHC) is subject to tax on his or her share of the corporation’s undistributed foreign personal holding company income,\textsuperscript{18} while an at least 10 percent U.S. shareholder of a controlled foreign corporation (CFC) is taxable on his or her share of certain items of income (including Subpart F income) realized by the corporation, including FPHC income.

Under the FPHC provisions, 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.\textsuperscript{20} Under the CFC provisions, 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 FPHC 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 FPHC income.\textsuperscript{21}

The nature of the income that a foreign corporation with U.S. shareholders receives also may 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. 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 passive foreign investment company (PFIC) by increasing its so-called passive income. Generally, if a U.S. shareholder of a PFIC does not elect to include in income currently his or her 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.\textsuperscript{22} Royalties for this purpose, however, do not include (1) those that are not treated as FPHC income under the CFC provisions and (2) royalties paid by a related person and allocable to that person’s nonpassive income.\textsuperscript{23}

\textsuperscript{15} Treas Reg §§ 1.469-2T(c)(3)(iii)(B), 1.469-2T(f)(7).
\textsuperscript{16} IRC § 469(e)(1)(A).
\textsuperscript{17} IRC § 469(c)(5).
\textsuperscript{18} See IRC § 551.
\textsuperscript{19} See IRC § 951.
\textsuperscript{20} See IRC § 553(a)(1), (2).
\textsuperscript{21} See IRC § 954(c)(1)(B), (2)(A), (3)(A)(ii) and (B).
\textsuperscript{22} See IRC §§ 1291, 1293.
\textsuperscript{23} Int. Rev. Code § 1297(b).
Significance of a Sale. To determine the nature of the income realized by the licensor of intellectual property, it is first necessary to determine whether a sale has occurred for tax purposes. In general, a taxpayer will be deemed to have sold intellectual property 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.24

The extent to which rights must be transferred in order to have 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. It seems reasonably clear that, under any analysis, a sale will not occur if the licensee agrees to allow the licensor to exploit the property in the same territory25 or if the licensee itself cannot use the property, at least when the right to use is a substantial one.26 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.27

Also, notwithstanding the general rule, certain special provisions in the Code may determine whether a sale has occurred for federal income tax purposes or may indirectly influence the analysis. These are discussed later in this article.

Treatment of Licenses. Important from the perspective of a licensor of intellectual property is the fact that a sale can occur notwithstanding the fact that the transaction is characterized as a license by the parties. Unlike nonexclusive licenses, exclusive licenses of intellectual property are typically viewed as sales for tax purposes.

Normally, an exclusive license to make, use, and sell property will be treated as a sale for tax purposes,28 even if the licensor retains certain protections such as the right to terminate the agreement if the licensee does not meet certain performance standards,29 as long as the exclusive right remains in effect for the full remaining life of the property to which it relates.30 Note, however, that commentary has suggested 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. antitrust laws.31

Nonexclusive Licenses

The discussion that follows focuses on the impact of nonexclusive licenses of patents, copyrights, know-how, computer software, and trademarks from the licensor’s perspective.

Patents, Copyrights, Know-How, and Computer Software. If the owner of a patent, a copyright, know-how, or computer software licenses it to a third party on a

24. See El duPont de Nemours & Co v United States, 288 F. 2d 904 (Ct Cl 1961); Rev Rul 55-540, 1955-2 CB 39; Rev Rul 60-226, 1960-1 CB 26. See also Treas Reg § 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.


26. See Waterman v Mackenzie, 138 US 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.

27. See United States v Carruthers, 219 F. 2d 21 (9th Cir 1955).

28. See Myers v Commr, 6 TC 258 (1946).

29. See Watson v United States, 222 F. 2d 689 (10th Cir 1955); Newton Insert Co v Commr, 61 TC 570 (1974).

30. See Rev Rul 84-78, 1984-1 CB 173.

basis that is not treated as a sale for federal income tax purposes, the income received by the licensor will be subject to tax at ordinary income rates.

The Tax Court found ordinary income, for example, when a taxpayer licensed technology to a Japanese corporation pursuant to a technology transfer agreement that was terminable at will after ten 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.32

Two interesting private letter rulings issued by the Internal Revenue Service (IRS) deal with the tax treatment of nonexclusive licenses on the death of the author of various copyrighted literary works, including the creation of a new tax basis on death.33

**Trademarks.** More complex statutory provisions apply when a trademark is licensed on a nonexclusive basis; however, they produce the same result, whether or not the royalty payments are contingent on the productivity, use, or disposition of the trademark.

To the extent the royalty payments are contingent on the productivity, use, or disposition of the trademark, the licensor will be treated as having received income from the sale or other disposition of a noncapital asset—that is, ordinary income.34

If the licensor 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 also will be treated as ordinary income by reason of the Code provision35 that 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:

- To set quality standards for the products to which the trademark is affixed;36 or
- To require the transferee to advertise only the licensor’s products,37 when, according to the Tax Court, the retained right is coextensive with the duration of the interest transferred.38

Note that a sale also will not be deemed to have occurred under this provision if the licensor retains the right to payments contingent on the productivity, use, or disposition of the trademark, but only if the payments constitute a substantial element under the transfer agreement.39

**Exclusive Licenses**

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

Different rules apply to exclusive (in contrast to nonexclusive) licenses of patents, copyrights, computer software, know-how, and trademarks. The discussion below assumes that the transaction does not involve a like-kind exchange.


33. See *Ltr Rul 9326043* (Apr 2, 1993); *Ltr Rul 9549023* (Sept 8, 1995).

34. IRC § 1253(c). With respect to prior law, see *Dairy Queen of Oklahoma, Inc v Commr*, 250 F. 2d 503 (10th Cir 1957).

35. IRC § 1253(a).

36. IRC § 1253(b)(2)(C).

37. IRC § 1253(b)(2)(D).


Patents

Statutory Safe Harbor. There is a statutory safe harbor, adopted in 1954, pursuant to which an individual holder of a patent who transfers to an unrelated party all substantial rights to the patent or an undivided interest in all substantial rights to the patent will realize long-term capital gain (or loss) regardless of whether the payments received in exchange are (1) payable periodically over a period generally coterminous with the assignee’s use of the patent (but see the discussion below) or (2) contingent on the productivity, use, or disposition of the patent.

The regulations indicate that this safe harbor provision can apply even before a patent has been issued or before a patent application has been filed.

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 a 1969 Tax Court decision), 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 the valuable rights covered by the patent.

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.

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.

Nevertheless, an employee hired to invent will realize ordinary income and not capital gain if he or she is bound to assign to his or her employer all patents that he or she obtains and all patentable inventions that he or she conceives in the course of his or her employment.

General Principles. If the safe harbor provision dealing with the transfer of patent rights does not apply, capital gains treatment still may be available under general federal income tax principles distinguishing capital assets from other property. The availability of capital gains treatment will depend initially on 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 is important to bear in mind why the safe harbor provision does not apply.

Even if a sale is deemed to have occurred, however, a professional inventor who

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41. IRC § 1235(a).
44. Treas Reg § 1.1235-2(b)(1), (c).
45. IRC § 1235(b), (d). With respect to the treatment of partners as holders, see Ltr Rul 200135015 (May 31, 2001); and Ltr Rul 200219017 (Feb 6, 2002).
46. Treas Reg § 1.1235-2(e).
47. See Treas Reg § 1.1235-2(c)(2); McClain v Commr, 40 TC 841 (1963).
is in the business of inventing and selling patents will realize ordinary income.\textsuperscript{50} Also, a transferor who used the patent in the ordinary course of his or her trade or business will derive either a capital gain or an ordinary loss under the provisions of Code Section 1231.\textsuperscript{51} Finally, although 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—\textsuperscript{52} that is, before property rights in the patent come into being.\textsuperscript{53}

**Copyrights.** There is less question about the nature of income derived from the license of a copyright once the transaction has been determined to be a sale for federal income tax purposes rather than a nonexclusive license or a payment of compensation for services rendered.\textsuperscript{54} With respect to the latter characterization, in a 1984 case applying the “work for hire” rule, the Tax Court found that the taxpayer realized compensation income because he had no copyrightable property interest in the recordings he made for a recording company.\textsuperscript{55}

The 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).\textsuperscript{56} The relevant Code provision applies to any property eligible for copyright protection under statute or common law, but not to a design that may be protected solely under patent law.\textsuperscript{57}

The income derived from the exclusive license of a copyright that is not a capital asset will always be ordinary in nature; however, the licensor should be able to recover his or her cost basis tax-free because, under the circumstances, the statute does not negate “sale or exchange” treatment.

In other cases, the licensor will realize capital gain, provided that the copyright was not held for sale to customers in the ordinary course of the licensor’s trade or business;\textsuperscript{59} the copyright was not used in the licensor’s trade or business\textsuperscript{50} or, if it was, the provisions of Code Section 1231 do not in effect cause the income to be recharacterized as ordinary in nature; and no portion of the price is imputed as interest under the provisions of Code Section 483 or 1274, both discussed later in this article.

**Computer Software.** In view of the fact that some computer software is now copyrightable and patentable, it is not clear whether an exclusive license of computer software must be analyzed as though it were the sale of a copyright or patent. The regulations under Code Section 1221 confuse the issue by specifically excluding from the term “capital asset” any property eligible for copyright protection, whether or not formal copyright protection is sought.\textsuperscript{60}

Nor is it clear whether, without the benefit of copyright or patent status, computer

\textsuperscript{50.} See Avery v Commr, 47 BTA 538 (1942).

\textsuperscript{51.} See IRC § 1221(2), indicating that depreciable property used in a trade or business does not constitute a capital asset.

\textsuperscript{52.} See Burde v Commr, 43 TC 252 (1964).

\textsuperscript{53.} See Diescher v Commr, 36 BTA 732 (1937).

\textsuperscript{54.} See Rev Rul 60-226, supra note 24.

\textsuperscript{55.} Boulez v Commr, supra note 2.

\textsuperscript{56.} IRC § 1221(3).

\textsuperscript{57.} See Treas Reg § 1.1221-1(c)(1). Note the ambiguous nature of the final sentence of this regulation.

\textsuperscript{58.} See IRC § 1231(b)(1)(C), preventing any such gain from being treated as capital in nature; Meisner v United States, 133 F. 3d 654 (8th Cir 1998).

\textsuperscript{59.} See IRC § 1221(1); Desilu Productions, Inc v Commr, TCM 1965-307.

\textsuperscript{60.} See IRC § 1221(2).

\textsuperscript{61.} Treas Reg § 1.1221-1(c)(1).
software can qualify as property and hence a capital asset, at least when it is not viewed by the owner as a trade secret. Note, however, that Code Section 167(f), dealing with depreciation, treats the computer software to which it applies as property.

The regulations recently promulgated under Code Section 861 are helpful, but not determinative, on the subject of what a transfer of computer software actually entails. For the purposes described in these regulations, the government recognizes 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, and the provision of know-how relating to computer programming techniques.

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.

Also, under certain circumstances, computer software may be deemed not to have been transferred separately, leaving the tax consequences of the transfer dependent on the tax impact of the underlying transaction. For example, in a 1994 Court of Claims decision 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 Code.

**Know-How.** There are no statutory provisions dealing specifically with the disposition of know-how. Under appropriate circumstances, however, know-how may be classified as a capital asset or may qualify for favorable federal income tax treatment under Code Section 1231, so that when a sale is deemed to have occurred, a taxpayer who disposes of know-how can realize capital gain.

Of primary concern here is whether know-how constitutes property. If it does not, it cannot qualify as a capital asset or as an asset eligible for the benefits of Section 1231. In the past, the IRS treated trade secrets as property, leaving doubt about the nature of other technological information.

Nevertheless, prior case law supports property characterization under other circumstances. In a 1993 Tax Court opinion, confidential, unpatented technology was viewed as property, and in a 1981 Tax Court decision, engineering proposals were found to incorporate “trade secrets, know-how, or unpatented technology protectable as a form of property.”

Moreover, the regulations under Code Section 197, dealing with the amortization of intangibles, which are discussed below, 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, even though these regulations decline to treat know-how to which the

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62. See the discussion of know-how, infra.
63. Treas Reg § 1.861-18(b).
64. See IRC §§ 1221(1), 1231(b)(1)(A).
66. IRC § 1221.
67. See Rev Rul 71-564, 1971-2 CB 179, dealing with the transfer of trade secrets to a corporation. See also Pickren v United States, supra note 32, describing secret formulas as capital assets.
70. Treas Reg § 1.197-2(g)(8).
provisions of Section 197 apply as property for all purposes under the Code.\footnote{71}{IRC § 197(f)(7) treats any amortizable IRC § 197 intangible as “property” subject to the allowance for depreciation.}

Assuming there is no imputed interest, a licensor who is deemed to have sold know-how that is treated as property will recognize capital gain unless (1) the know-how is deemed to have been sold to customers in the ordinary course of the licensor’s trade or business; (2) the gain is in effect recharacterized as ordinary income under Section 1231; or (3) the licensor is a professional inventor or an employee who is obligated to transfer all inventions to his or her employer.\footnote{72}{See Taylor-Winfield Corp v Commr, 57 TC 205 (1971).}

If the taxpayer has any basis in the transferred know-how, it will reduce his or her income. By way of footnote, however, it is important to understand that under certain circumstances, know-how may be deemed not to have been transferred separately, leaving the tax consequences of the transfer dependent on the tax impact of the underlying transaction.\footnote{73}{See Syncsort, Inc v United States, supra note 65.}

**Trademarks**

**Retaining No Interest.** The nature of the income that a taxpayer receives on licensing a trademark without retaining any significant power, right, or continuing interest with respect to the subject matter of the trademark will depend on the nature of the consideration paid.

The 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 noncapital asset. Hence, there will be ordinary income.\footnote{74}{IRC § 1253(b)(2)(F).} Because Code Section 1253(c) does not negate the occurrence of a “sale or exchange,” however, the taxpayer will presumably not be taxed on his or her basis in the property transferred.

Otherwise, the general tax principles distinguishing ordinary income from capital gain, which are discussed above, will apply.

**Retaining an Interest.** 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 the trademark (such as quality control rights) will not be deemed to have sold or exchanged a capital asset\footnote{75}{IRC § 1253(a), (b)(2).} and hence will realize ordinary income.

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.\footnote{76}{See IRC § 1253(b)(2)(F).}

Nevertheless, for purposes of determining whether the transaction gives rise to personal holding company income (discussed earlier), the transaction still may be regarded as a sale.\footnote{77}{See Tomerlin Trust, Transferee v Commr, supra note 5.}

**Special Issues Impacting Exclusive Licenses**

**Generally.** Although a licensor will typically realize capital gain when a sale of intellectual property is deemed to have occurred, under certain circumstances some portion of the amount realized may be treated as ordinary income. Another portion of the consideration may be viewed as a tax-free return of basis. These general recharacterization provisions are discussed below.

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71. IRC § 197(f)(7) treats any amortizable IRC § 197 intangible as “property” subject to the allowance for depreciation.
73. See Syncsort, Inc v United States, supra note 65.
74. IRC § 1253(c).
75. IRC § 1253(a), (b)(2).
76. See IRC § 1253(b)(2)(F).
77. See Tomerlin Trust, Transferee v Commr, supra note 5.
Recapture Income. Even if the licensor is deemed to have sold a capital asset, there will be some ordinary recapture income if the licensor previously was able to depreciate or amortize the cost of the asset. Intangible property, the cost of which is now amortizable over a period of 15 years, is treated as depreciable property for this purpose.

An amount equal to the research and experimental expenditures that a taxpayer elects to expense under Code Section 174(a), however, will not be subject to taxation at ordinary income rates when the taxpayer later sells the resulting technology at a gain. A 1985 IRS ruling rejects the applicability of the so-called tax benefit doctrine under these circumstances.

Imputed Interest. In addition, even if the licensor 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 Code if there is no stated interest or if the interest to be paid falls short of the statutory safe harbor amount.

If the license involves the transfer of a patent described in Code 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. The IRS 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, although 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.

In all other cases, one of two imputed interest provisions (Code 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. 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, and some portion of the price is payable more than one year after the sale occurs.

In general, if the provisions of Section 1274 apply, original issue discount will be imputed if the interest provided for is inadequate, 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. Under some circumstances, however, a special election to report imputed interest as payments are made may be available.

Basis Recovery. Another question faced by licensors who are deemed to have sold
intellectual property relates to the determination of the amount of gain. If all consideration is paid up front, gain represents the difference between the amount realized and the tax basis of the property. On the other hand, if some part of the transfer price is payable over time, the transferor must determine when the property’s tax basis can be recovered tax free.

If the sale price is fixed in amount and duration and the taxpayer chooses to report gain on the installment method, the taxpayer will recover his or her basis in the property transferred proportionately as payments of principal are made. If the purchase price is contingent in amount or in duration, or both, however, the proration formula can work only if certain assumptions about the price are made.

The installment sale regulations indicate what to do when either (1) 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 (2) 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 IRS to use a different basis recovery method.

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 IRS. 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.’”

Related-Party Transactions. Apart from the general recharacterization provisions discussed above, several Code provisions convert what might otherwise be capital gain into ordinary income when the licensor and licensee in a transaction viewed as a sale for tax purposes are related. Under other circumstances, the related-party rules in the statute will preclude the licensor from claiming an immediate tax loss incident to a transaction viewed as a sale for tax purposes.

Patents. The provision pursuant to which the holder of a patent can realize capital gain when he or she transfers the patent does not apply if the transferee is a related party. Capital gains treatment still may be available under general principles of federal income tax law; however, the government will be reluctant to allow capital gains treatment if the transferor would have realized ordinary income had he or she, instead of the related party, exploited the patent.

Depreciable Property. Under Code Section 1239, a licensor who is deemed to have sold property to a related person will realize ordinary income if the property is

90. See IRC § 1001(a), (b).
91. IRC § 453.
92. With respect to the deferral charge that may be due if installment reporting is selected, see IRC § 453A.
93. See Treas Reg § 15A.453-1(c), which also recognizes the income forecast method for basis recovery under appropriate circumstances; AMC Partnership v Commr, TCM 1997-115.
95. See IRC § 1235(d); Soffron v Commr, 35 TC 787 (1961).
96. See Rev Rul 69-482, supra note 49.
97. See Van Dale Corp v Commr, 59 TC 390 (1972), in which the government sought to apply IRC § 482.
depreciable in the hands of the licensee, the concern here being with a licensor’s ability to generate ordinary deductions in the future (through a related party) by paying currently a tax at favorable capital gain rates. Note that installment sale treatment, discussed above, will generally not be available under these circumstances as well.98 A patent application is deemed to be depreciable for this purpose.99

Similarly, property that is not a capital asset in the hands of the transferee (and that, if later sold by the transferee, thus normally will yield ordinary income) will generate ordinary income for the transferor 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 own more than a 50 percent interest in the partnership.100

Finally, a U.S. licensor who is deemed to have sold a patent, copyright, secret process or formula, or similar property to a foreign corporation that the licensor controls will realize ordinary income rather than capital gain.101 Control for this purpose means the direct or indirect ownership of more than 50 percent of the voting stock of the entity.

Disallowed Losses. In a related-party transaction, a transferor may be precluded from treating any realized income as capital gain. Conversely, the transferor may be unable to derive a current tax benefit from a loss realized in a transaction involving a related party, given the legislative concern about the ability of related parties to create uneconomic tax losses.

Thus, should a licensor be deemed to have sold intellectual property at a loss to a person related to the licensor, the loss, as such, normally will not be deductible currently.102 If the licensor and the licensee are members of the same controlled group of corporations, the loss typically will be deferred.103 The regulations apply consolidated return principles under these circumstances. Otherwise, the licensee may reduce his or her subsequent gain by the amount of the loss disallowed on the initial sale.105

Source of Income

Royalties. A licensor 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 her U.S. tax liability. Special sourcing rules apply to royalty income, assuming it does not in fact represent compensation for services rendered,106 normally sourced where the services were performed.

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.108 Royalties paid for use abroad of, or for the

98. See IRC § 453(g), which extends the definition of “related persons” beyond that in IRC § 1239.
99. Note that in Ltr Rul 199944045 (Aug 11, 1999), the provisions of IRC § 1239 were found not to apply to the transfer of a trademark.
100. IRC § 707(b)(2). (3).
101. IRC § 1249.
102. IRC § 267(a)(1) and, with respect to transactions involving partnerships or a partner and a partnership, IRC § 707(b)(1).
103. IRC § 267(f).
104. Treas Reg § 1.267(f)-1.
105. IRC § 267(d).
106. See Rev Rul 84-78, supra note 30.
108. IRC § 861(a)(4). Note, in this regard, the distinction drawn in Treas Reg § 1.861-18 between the lease of a copyright-ed computer program (generating rental income) and the license of the copyright right itself (generating royalty income).
privilege of using abroad, patents, copyrights, secret processes and formulas, trademarks, and like property are sourced outside the United States. 109 Thus, the place where the licensee uses or is entitled to use the intellectual property is controlling. 110

**Purchase Price.** A taxpayer who conducts business both in the United States and abroad also must determine the source of his or her 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 her U.S. tax liability.

There is a special 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, to the extent the payments received constitute purchase price.111 In general, a U.S. resident taxpayer who sells personal property (1) 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 attributed112 and (2) 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.113

Intangibles, on the other hand, including patents, copyrights, secret processes and formulas, and trademarks, are treated differently from other personal property,114 although under certain circumstances, the IRS 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.115 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 (except for Code Section 865(c)(2), relating to gain in excess of depreciation) will normally apply. 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 above will apply, but only to the extent that the gain exceeds any tax depreciation allowable with respect to the property sold. 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 on the proportionate amount of the depreciation adjustments allocable to each source, if tax depreciation was allowable with respect to the property sold.116

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 the United States if, under a treaty obligation, it would be sourced abroad.

**Cross-Licenses**

A licensor who licenses intellectual property on either an exclusive or a nonexclu-
sive basis in exchange for cash consideration will face the issues addressed above. If, however, a transaction involves cross-licenses of property not terminable at will by either party, it may qualify as a like-kind exchange. Then, depending on the facts, neither party to the transaction may be required to recognize any taxable income. Pursuant to the statute, the properties involved must be of like kind and must be held for productive use in a trade or business or for investment.

To determine whether intangible properties are of like kind, the regulations focus on 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. The IRS recently ruled, however, that a taxpayer could swap Federal Communications Commission (FCC) broadcast station licenses on a tax-free basis, even though one related to radio and the other to television.

THE LICENSEE’S PERSPECTIVE

Overview
The focus of a licensee is on tax deductibility. In theory, it would seem that all license fees paid by a licensee should be treated just like rent—i.e., they should be deductible currently as an ordinary and necessary business expense, when paid or accrued. The actual tax consequences of a license arrangement from the licensee’s perspective, however, will depend on the nature of the intellectual property involved and on whether a sale is deemed to have occurred. Note that even if an up-front technology transfer fee is paid, the transaction can be characterized as a license rather than a sale for tax purposes. Also relevant is whether the license is entered into in the ordinary course of business or, instead, incident to the acquisition of a business.

Licenses Incident to the Acquisition of a Business
A licensee who licenses intellectual property incident to the acquisition of a business will generally be treated differently from a licensee who licenses intellectual property in the ordinary course of business. The provisions impacting those who license patents, copyrights, know-how, computer software, and trademarks incident to the acquisition of a business are discussed below.

Patents, Copyrights, and Know-How. The Omnibus Budget Reconciliation Act of 1993 added to the Code a provision dealing specifically with the amortization of intangibles, including intellectual property. This provision generally impacts intangibles acquired after August 10, 1993, when the legislation was enacted, although taxpayers were given an elective right to apply the provision to intangibles acquired after July 25, 1991.

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 busi-

117. IRC § 1031.
118. See TAM 9222005 (Jan 10, 1992).
119. Treas Reg § 1.1031(a)-2(c).
120. TAM 200035005 (May 11, 2000). See also TAM 200224004 (June 14, 2002).
121. See also Rev Rul 81-178, 1981-2 CB 135, distinguishing royalties from compensation for services rendered; Speer v Comm’r, TCM 1996-323, in which the government sought to characterize license payments as a constructive dividend.
122. IRC § 197.
123. Temp Treas Reg § 1.197-1T; Treas Reg § 1.197-2(l); IRS Notice 94-90, 1994-2 CB 561.
ness or a substantial portion of a trade or business are covered under Code Section 197. Any purchased “formula, process, design, pattern, know-how, format, or other similar item” also is 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.

The entire adjusted basis of a patent, a copyright, or know-how to which Section 197 applies can be deducted ratably over a period of 15 years, beginning with the month of acquisition. The regulations promulgated under Section 197 indicate that a taxpayer cannot avoid 15-year amortization simply by entering into a license. The regulations as initially proposed included only a very narrowly drawn provision permitting certain licensees under certain circumstances to treat their license fees as though Section 197 did not exist. The business community found the license exception in the proposed regulations too narrow to be helpful.

The final regulations, although retaining the old exception, include two new exceptions, one of which is relevant to a taxpayer who licenses a patent, a copyright, or know-how in connection with his or her acquisition of a trade or business. Under this exception, the licensee will not be required to capitalize under Section 197 the amount payable to the licensor as long as the consideration is 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. The government will apply the provisions of Code Section 1235, which are discussed earlier, when deciding whether a transfer of all substantial rights has occurred.

As a result of this exception, all license fees paid by a taxpayer who takes a nonexclusive license under a patent or secures a nonexclusive license to use a copyright or know-how incident to a business acquisition should continue to be deductible on an essentially pay-as-you-go basis. The actual timing of the deduction may depend on the taxpayer’s method of accounting; however, if the consideration consists in whole or in part of an up-front payment, the licensee will presumably be required to amortize the payment ratably over the term of the license. 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.

Computer Software. Today, a taxpayer who licenses computer software for use in a trade or business also must focus on the impact of Code Section 197.

124. See IRC § 197(d)(1)(C)(iii), (e)(4)(C); Treas Reg § 1.197-2(b)(5), (c)(7).
125. See IRC § 197(c)(2), (d)(1)(C)(iii); Treas Reg § 1.197-2(b)(5), (d)(2)(iii)(B).
126. The final regulations published in the Federal Register on Jan 25, 2000, discuss the mechanics of amortization, including the date on which amortization begins. See Treas Reg § 1.197-2(f).
127. Treas Reg § 1.197-2(b)(11).
128. Treas Reg § 1.197-2(c)(13).
130. See Treas Reg § 1.197-2(a)(3).
131. See IRS Field Service Advice 199941018 (July 12, 1999), dealing with the amortization of the value of stock warrants granted to a licensor of technology.
132. See Treas Reg § 1.263A-1(e)(3)(ii)(P). This regulation has been promulgated under the so-called uniform capitalization provisions of IRC § 263A. In general, those provisions require a taxpayer to capitalize all direct and allocable indirect costs of tangible (but not intangible) personal property produced by the taxpayer or acquired by the taxpayer for resale. With respect to the capitalization of patent royalty payments and their inclusion in ending inventory, see Plastic Engineering & Technical Services, Inc, TCM 2001-324.
Computer software (that is, in general, any program designed to cause a computer to perform a desired function) is covered under Section 197 if two requirements are met. First, the software must be customized (that is, (1) not readily available for purchase by the general public; (2) subject to an exclusive license; or (3) substantially modified). Second, the software must be deemed to have been acquired in connection with the acquisition of assets constituting a trade or business or a substantial portion of a trade or business. In addition, based on the legislative history, the capital cost of the software cannot be required to be taken into account as part of the cost of computer hardware or other tangible property.

A taxpayer cannot avoid 15-year amortization simply by licensing customized computer software in connection with a business acquisition; however, a taxpayer who does so can take advantage of the license exception available to licensees of patents, copyrights, and know-how described above. In other words, as long as the consideration is arm’s-length in amount and the license does not transfer all substantial rights to the computer software, the licensee will be able to avoid Section 197 amortization.

One of two rules will apply when Section 197 does not apply. First, if the licensee acquires the computer software in a transaction viewed as a sale for tax purposes, the total consideration will be depreciable on a straight-line basis over a period of 36 months. This approach replaces the approach taken by the IRS in a revenue procedure issued in 1969, 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. The current 36-month amortization period begins with the month in which the computer software is placed in service. It is still true, however, that a licensee who acquires computer hardware and computer software for a single stated price must treat the total purchase price as a payment for depreciable hardware.

Under the second rule applicable when Section 197 does not apply, a taxpayer who licenses computer software 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 and the transaction is not treated as a sale for tax purposes. If the consideration consists of a single up-front lump-sum payment, however, presumably the licensee will be required to amortize the payment ratably over the term of the license.

133. See IRC § 197(e)(3); Treas Reg § 1.197-2(c)(4).
134. Note that the House Report on the Omnibus Budget Reconciliation Act of 1993 (HR Rep No 103-111, 103d 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.
136. Treas Reg § 1.197-2(b)(11).
140. See, however, Sprint Corp v Commr, 108 TC 384 (1997), in which software loads acquired with digital switches were found to be depreciable as tangible personal property.
141. Treas Reg § 1.167(a)-14(b)(1).
142. See HR Rep No 103-111, 103d Cong, 1st Sess 767 (1993); Treas Reg § 1.167(a)-14(b)(2).
143. Treas Reg § 1.167(a)-14(b)(2); Rev Proc 2000-50, supra note 138.
144. Cf Treas Reg § 1.167(a)-14(b)(1).
Trademarks. The new amortization provisions under Section 197 affect all trademark acquisitions except those covered by that provision of Code Section 1253 that was not repealed by the 1993 legislation. Unfortunately, the license exception in the regulations discussed above does not cover trademark licenses.145

Thus, there are only two trademark rules. Under the first, which appears in Section 1253(d)(1), a taxpayer who enters into a license to use a trademark, whether or not the license is treated as a sale for tax purposes,146 will be able to deduct his or her royalty payments currently as an ordinary and necessary business expense if the payments (1) are contingent on the productivity, use, or disposition of the trademark; (2) payable at least annually throughout the term of the transfer agreement; and (3) substantially equal in amount or payable under a fixed formula.147

All payments, other than those to which Section 1253(d)(1) applies, now must be capitalized,148 and the capitalized amount can be amortized pursuant to Section 197 over a period of 15 years.149 This provision applies, for example, to the cost of renewing a license to use a trademark.150

The 15-year amortization provision is generally more liberal than previous law. Prior to 1993, depending on the circumstances, lump-sum payments of up to $100,000 were amortizable over no more than ten 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 ten years or over the term of the license agreement, was 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 all amounts due and was able to depreciate them over the useful life of the acquired property if a limited life was ascertainable.151

Note, however, that in general, under the uniform capitalization provisions of Code 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.152 Indirect costs include the fees incurred to secure the right to use a trademark associated with property produced or acquired for resale.153

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.

Amortization of License Fees. If a licensee of intellectual property determines that Section 197 amortization applies to his or her license fees, the mechanics of amortization become relevant.

Fixed Fees. If a licensee pays only an up-front technology transfer fee to acquire

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145. Treas Reg § 1.197-2(f)(3)(ii)(B) does not cover intangibles described in ¶(b)(10) of the regulations, dealing with franchises, trademarks, and trade names.
146. See IRC § 1253(a), (b)(2), discussed earlier in this article.
147. IRC § 1253(d)(1), as amended by the Revenue Reconciliation Act of 1989.
148. IRC § 1253(d)(2) as now in effect.
149. See IRC § 197(c)(2), (d)(1)(F), (f)(4)(C); Treas Reg § 197-2(b)(10).
150. See IRC § 197(f)(4)(B).
151. IRC § 1253(d)(2), (3), as in effect after the Revenue Reconciliation Act of 1989 and before the Omnibus Budget Reconciliation Act of 1993. Note that different rules applied to transactions treated as a sale or exchange under IRC § 1253(a). For a case decided under the law as in effect in 1982 and 1983, see Nabisco Brands, Inc v Commr, TCM 1995-127.
152. IRC § 263A(a), (b)(2).
an intangible subject to Section 197 amortization, the computation of the annual amortization deduction is not difficult, once the first day of the amortization period is determined.\textsuperscript{154} It is, however, difficult to determine how to treat the fixed cost of an intangible payable over a period of years in the form of license fees.

The final regulations deal in two different ways with the consideration for an amortizable Section 197 intangible payable over a period of time yet fixed in amount. As a general rule, fixed amounts payable in the future under a license to which the provisions of Section 197 apply will be deemed to be due under a debt instrument.\textsuperscript{155} Thus, some portion of each payment will constitute imputed interest and the rest will be amortizable based on the taxpayer’s method of accounting. If, under the taxpayer’s method of accounting, a basis increase occurs after the beginning of the 15-year amortization period, so-called backloading will occur because each basis increase will be amortizable ratably over the balance of the 15-year period remaining after the date of the increase.\textsuperscript{156}

The final regulations take a different approach to Section 197 intangibles acquired in a transaction involving the actual or deemed acquisition of the assets of a trade or business—that is, involving either an applicable asset acquisition under Code Section 1060 or a qualified stock purchase under Code Section 338(d)(3). The basis rules under these provisions will govern the treatment of future payments of the purchase price.\textsuperscript{157} Then, if a licensee is deemed to have bought a Section 197 intangible for a fixed price, an immediate basis increase will occur, thereby avoiding backloading. Under these circumstances, the present value of the license fee must be ascertained.

**Contingent Fees.** The deferred portion of the amount paid to acquire a Section 197 intangible can be contingent rather than fixed in amount, and under the final regulations different rules apply to contingent payments subject to Section 197 amortization.

The final regulations provide that purely contingent payments do not become amortizable until they are paid and when paid, they must be amortized over the balance of the 15-year amortization period beginning with the date on which the intangible first became amortizable.\textsuperscript{158} The final regulations also conclude, however, that under some circumstances, a portion of each contingent payment will constitute interest. Contingent amounts due or deemed to be due under a debt instrument are deemed to include an interest element, while other contingent payments are not.\textsuperscript{159}

Assume, for example, that a corporate taxpayer acquires a trade or business and, as part of the acquisition, licenses all rights under a patent with a remaining term of less than 15 years for a license fee equal to a percentage of the revenues derived from products using the patented technology. This transaction involves a deemed debt instrument within the meaning of the final regulations because it is given in consideration for what the regulations treat as a sale or exchange of the underlying patent; the corporation is in effect acquiring all substantial rights to the patent. Hence, the principal portion of each contingent payment will be deductible, once paid, over the remainder of

\textsuperscript{154} The final regulations state that amortization must begin on the later of the first day of the month during which the IRC § 197 intangible is acquired or on the first day of the month in which the conduct of the trade, business, or income-producing activity begins. Treas Reg § 1.197-2(f)(1).

\textsuperscript{155} See Treas Reg § 1.197-2(f)(3)(iv)(B)(1). Query whether it is relevant that the license is nonexclusive.

\textsuperscript{156} See the discussion of contracts for the use of an IRC § 197 intangible in the preamble to the final regulations, appearing in TD 8865 published in the Federal Register on Jan 25, 2000.

\textsuperscript{157} Treas Reg § 1.197-2(f)(4)(ii).

\textsuperscript{158} Treas Reg § 1.197-2(f)(2)(i), (ii).

\textsuperscript{159} Treas Reg § 1.197-2(f)(2)(iii).
the 15-year amortization period. The 15-year amortization period starts on the first day of the month during which the corporation buys the business. The remainder of the 15-year amortization period will begin on the first day of the month in which the contingent payment occurs.

Note that, under the final regulations, contingent payments that are not due or deemed to be due under a debt instrument appear to be amortizable in full over the appropriate period of time. That is, it appears that no portion will be viewed as interest.160

Licenses in the Ordinary Course of Business

Code Section 197 is less relevant to those who license intellectual property outside of the context of a business acquisition, but not totally irrelevant. Other Code provisions become relevant under these circumstances as well.

Patents and Copyrights. A taxpayer who takes a nonexclusive license under a patent or who secures a nonexclusive license to use a copyright in the ordinary course of business need not worry about the amortization provisions of Section 197. The fees paid by the licensee under these circumstances should be treated essentially in the same manner as the fees paid by a taxpayer who is not required to apply the provisions of Section 197 to a license (in contrast to a sale) of computer software entered into incident to a business acquisition. That is, the licensee typically will be treated just like a business lessee for tax purposes if the consideration is payable in the form of an annual royalty and the transaction is not treated as a sale for tax purposes. If the consideration consists of a single up-front lump-sum payment, presumably the licensee will be required to amortize the payment ratably over the term of the license.161

If the license arrangement is viewed as a sale for tax purposes, however, the consideration is eligible for depreciation under Code Section 167, as amended by the Omnibus Budget Reconciliation Act of 1993.162 Two separate depreciation regimes for patents and copyrights exist under this provision.

In 1945, the Tax Court concluded that, when the acquisition price of a patent consists of periodic payments contingent on use, the actual payments made may be deducted as depreciation.163 This principle (the variable contingent payment method of depreciation) holds true today.164 The House Report on Section 197 in fact 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.165

The language in the House Report has been reflected in the final regulations under Section 167(f)(2), and the principle has been extended to cover copyrights.166

160. Treas Reg § 1.197-2(f)(2)(iii) refers to Treas Reg § 1.461-1(a)(1), (2).
161. See supra notes 142 and 143.
162. See IRC §§ 167(f)(2), 197(e)(4)(C).
163. Associated Patentees, Inc v Commr, 4 TC 979 (1945).
164. See Newton Insert Co v Commr, supra note 29, and Rev Rul 67-136, 1967-1 CB 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.
166. Treas Reg § 1.167(a)-14(c)(4).
If the variable contingent payment method does not apply, the amount paid for a patent or a copyright can be deducted over its remaining useful life. Thus, when a fixed lump-sum amount is paid for a patent, it will normally be amortizable ratably over the remainder of the statutory life of the patent. In the case of a design patent, the statutory life is 14 years from date of issue. 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.

In the past, it was recognized that special circumstances might call for a different treatment of the amount paid for a patent. The amount 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 on the ratio of the number of days of expiring life in a particular year to the total annual days of unexpired life for the entire group. Also, under appropriate circumstances, the income forecast method was stated to be available. Section 167(g)(6), added by the Taxpayer Relief Act of 1997, makes the income forecast method available with respect to patents, and this provision is reflected in the final regulations. It is not clear, however, how group acquisitions of patents will be treated under the final regulations.

Insofar as a copyright is concerned, the ability to deduct the amount paid over its remaining useful life is not particularly helpful. The effect of the Copyright Act of 1976, as amended, has been to extend the depreciation period beyond one that is useful for tax purposes when the taxpayer is unable to establish a useful life shorter than the remaining statutory life of the copyright. 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 Copyright Term Extension Act, enacted in 1998, replaced 50, 75, and 100 years with 70, 95, and 120 years, respectively; however, under appropriate circumstances, the income forecast method may be used for copyrights.

**Know-How.** The broad scope of Section 197 is particularly evident when taxpayers are faced with determining how to treat fees paid in the ordinary course of business to a licensor of know-how. The amount paid to acquire know-how in the ordinary course of business is subject to the new 15-year amortization provisions under Section 197; only self-created know-how is treated differently. Thus, to avoid capitalization and a 15-year write-off, a licensee of know-how must look for an exception to the general rule.

There are two helpful exceptions in the final regulations promulgated under Section 197. The first was introduced when the regulations were finalized. License fees paid pursuant to a license of know-how unconnected with the purchase of a trade or business need not be capitalized as long as the license itself is not deemed to involve a

167. Treas Reg § 1.167(a)-6(a), 1.167(a)-14(c)(4).
168. See Hazeltine Corp v Commr, 89 F. 2d 513 (3d Cir 1937); Kraft Foods Co v Commr, 21 TC 513 (1954); Simmonds Precision Products, Inc v Commr, 75 TC 103 (1980).
170. Treas Reg § 1.167(a)-14(c)(4).
172. IRC § 167(g)(6); Treas Reg § 1.167(a)-14(c)(4). See TAM 8501006 (Sept 24, 1984). With respect to the Copyright Term Extension Act, see Eldred v. Ashcroft, 123 S Ct 769 (2003).
173. IRC § 197(c)(2), (d)(1)(C)(ii); Treas Reg § 1.197-2(b)(5), (d)(2).
sale or exchange. To determine whether a transaction involves a sale or exchange, the government will look to the principles under Code Section 1235, discussed above.

A know-how licensor who is unable to establish the absence of a sale or exchange may be able to rely on a second exception in the regulations dealing with certain rights of fixed duration or amount. This is an exception that Congress expected the government to develop. The statute specifically excludes from the term "Section 197 intangible," to the extent provided in regulations, any right under a contract with a fixed duration of under 15 years if acquired other than incident to the acquisition of a business.176

Thus, a taxpayer who, in the ordinary course of business, licenses know-how for a period of not more than 15 years pursuant to an arrangement that could be viewed as a sale will, nevertheless, be able to deduct his or her license fees on essentially a pay-as-you-go basis. The actual timing of the deduction may depend on the taxpayer's method of accounting. If the consideration due consists in whole or in part of an up-front lump-sum payment, however, the taxpayer will presumably be required to amortize the payment ratably over the term of the license. 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 know-how is used.177

In all other circumstances, a licensee of know-how will have to deal with 15-year amortization and the amortization mechanics discussed above.

Computer Software. The deductibility of the cost of computer software licensed in the ordinary course of business is not addressed under Section 197; the software to which Section 197 applies must be customized and acquired incident to the acquisition of a business. Hence, licensees of computer software in the ordinary course of business are treated no differently from taxpayers who license noncustomized computer software incident to the acquisition of a business.

Trademarks. Consistent with the fact that trademarks are a special breed under the Code, licenses of trademarks in the ordinary course of business are treated differently from computer software licenses under similar circumstances.

If the license fee is contingent on the productivity, use, or disposition of the trademark and is payable throughout the term of the license agreement in at least annual installments that are either substantially equal in amount or payable under a fixed formula, the licensee of a trademark who enters into the license in the ordinary course of business will be able to deduct each installment payment as an ordinary and necessary business expense. In general, the provisions of Section 197 will apply under all other circumstances, forcing the licensee to deal with the mechanics of 15-year amortization.180

Unfortunately, the exception available to licensees of know-how pursuant to contracts with a fixed duration of under 15 years is not available to licensees of trademarks. Although the statute itself does not carve out trademark licenses, the final regu-

175. Treas Reg § 1.197-2(c)(13). Note, also, that the exception covers, under the same circumstances, any contract right that is fixed as to amount and the adjusted basis of which is properly recoverable under a method similar to the unit-of-production method.
176. IRC § 197(e)(4)(D).
177. See supra notes 130 to 131.
178. IRC § 197(e)(3).
180. IRC § 197(d)(1)(F); Treas Reg § 1.197-2(b)(10).
The only potentially helpful exception in the final regulations is that dealing with licenses unconnected with the purchase of a trade or business when the license itself is not deemed to involve a sale or exchange. The first question this provision raises is whether an intangible contract right described in subsection (b)(11) of the regulation also constitutes “property” described in regulation subsection (b)(10). If it does not, the exception is potentially available, raising the question whether or not a sale or exchange has occurred. The relevant Section 1235 principles indicate that a sale or exchange will be deemed to have occurred if the licensee receives all substantial rights to the trademark. What is not clear is how the government will determine whether substantial trademark rights have been transferred if the exception is potentially available.

**Payments to a Foreign Licensor**

Licensees of intellectual property need be concerned not only about the deductibility of their license fees but also about whether they must collect U.S. taxes from the fees they pay to foreign licensors. As a threshold matter, the licensee must determine the character of the licensor’s income—that is, in general, royalties for the use of intellectual property or income from the sale of personal property.

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

If the payments constitute a royalty for the use of, or the privilege of using, a patent, copyright, secret process or formula, or trademark in the United States, withholding at the statutory rate of 30 percent or at the lower treaty rate will be required 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 Code Section 871(b) or 882(a). Note that under most treaties to which the United States is a party, royalties are taxed at less than 30 percent unless the limitation-on-benefits article precludes use of the lower rate. 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 or formula.

If the payments constitute a royalty for the use of, or the privilege of using, a patent, copyright, secret process or formula, or trademark outside the United States, withholding will not be required, although the recipient may be taxed on payments in the United States if he or she maintains a fixed place of business (or permanent estab-
lishment) within the United States.\textsuperscript{192} 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 the United States.\textsuperscript{193}

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.\textsuperscript{194} 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.\textsuperscript{195}

**Purchase Price.** A licensee who is deemed to have bought intellectual property from a licensor who is a nonresident alien individual, a foreign corporation, or a foreign partnership must also determine whether U.S. taxes are required to be withheld from the license fee. The licensee's withholding obligations are dependent on the nature of the payments. For example, the payments made to a licensor may include compensation for services performed and unstated interest on that portion of the price not immediately payable when the transaction occurs.

If a nonresident alien individual, a foreign corporation, or a foreign partnership licenses a patent, copyright, secret process or formula, or trademark or similar property in a transaction viewed as a sale for tax purposes 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,\textsuperscript{196} withholding at the statutory rate of 30 percent or at the lower treaty rate generally will be required\textsuperscript{197} unless the payments are effectively connected with the licensor’s conduct of a trade or business in the United States and thereby includable in the licensor’s U.S. tax base.\textsuperscript{198}

Other gains, however, will be exempt from withholding, assuming that backup withholding at the applicable rate (until the 2001 legislation, 31 percent) is not required.\textsuperscript{199} Nevertheless, these other gains may be taxable under the Code provision\textsuperscript{200} dealing with U.S.-source capital gains realized by nonresident aliens present in the United States for at least 183 days.\textsuperscript{201} Such gains also may be includable in the licensor’s U.S. tax base should the licensor maintain a fixed place of business (or permanent establishment) in the United States through which the transaction is consummated.\textsuperscript{202}

If any portion of the purchase price is viewed as interest, withholding on the

\textsuperscript{192.} See IRC § 864(c)(4)(B)(i).
\textsuperscript{193.} Rev Rul 55-17, supra note 190. See Miller v Conne, TCM 1997-134. With respect to the source of compensation income generally, see IRC §§ 861(a)(3), 862(a)(3).
\textsuperscript{194.} See 91 Tax Notes Today 237-51 (Nov 20, 1991); 92 Tax Notes Today 199-75 (Oct 1, 1992).
\textsuperscript{195.} See also the preamble to Prop Treas Reg § 1.861-18, published in the Federal Register on Nov 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.
\textsuperscript{197.} See IRC §§ 1441, 1442.
\textsuperscript{198.} IRC §§ 871(b), 882(a). See IRC § 864(c). For a discussion of this provision and the law in effect before 1967, see Rev Rul 71-231, 1971-1 CB 229. See also Commr v Celanese Corp of America, 140 F. 2d 339 (DC Cir 1944).
\textsuperscript{199.} See IRC § 3406.
\textsuperscript{200.} IRC § 871(a)(2).
\textsuperscript{201.} See Rev Rul 78-253, 1978-1 CB 220, decided under prior law.
\textsuperscript{202.} See IRC § 865(e)(2), dealing with the sale or exchange of a capital asset. See also IRC § 864(c)(4)(B)(iii).
interest portion may not be required if it is viewed as original issue discount on portfolio indebtedness.\textsuperscript{203} Nor, to the extent the payments are found to constitute compensation for services rendered, will withholding be required if the services were performed outside the United States.\textsuperscript{204}

**FORMATION OF A JOINT VENTURE**

**Using a Corporation**

**Transfers to a Domestic Corporation.** 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.\textsuperscript{205} The statutory requirements for nonrecognition appear in Code Section 351. In general, 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. In addition, the transferor must, alone or with other transferors, own immediately after the exchange stock possessing at least 80 percent of the corporation’s voting power and at least 80 percent of all other classes of corporate stock.

Section 351 applies only to transfers of property.\textsuperscript{206} Patent rights have been determined to be property under Section 351,\textsuperscript{207} as have computer software,\textsuperscript{208} copyrights,\textsuperscript{209} and trademarks.\textsuperscript{210} The IRS has concluded, however, that the right to receive license fees in the future is not property.\textsuperscript{211}

The government’s characterization of know-how for purposes of Section 351 is less certain than its characterization of other forms of intellectual property. The IRS appears to view secrecy as an essential element of the technological information to which the provisions of Section 351 can apply.\textsuperscript{212} It has characterized know-how as secret when (1) 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 (2) adequate safeguards are taken to prevent unauthorized disclosure.\textsuperscript{213}

A transfer also is required under Section 351. For rulings purposes, the IRS has taken a restrictive posture regarding the extent of the rights in intellectual property that

\textsuperscript{203} See IRC §§ 871(a)(1)(A) and (C), 871(h), 881(a)(1) and (3), 881(c). For a situation involving original issue discount associated with the acquisition of patent rights, see IRS Field Service Advice 199922024 (June 4, 1999).

\textsuperscript{204} See Rev Rul 55-17, supra note 190, and Prop Treas Reg § 1.861-4(b), discussing the source of income from services performed partly within and partly outside the United States.

\textsuperscript{205} With respect to the transfer by a tax-exempt organization of intellectual property rights to a taxable subsidiary, see Ltr Rul 9705028 (Nov 5, 1996).

\textsuperscript{206} See generally Ltr Rul 8432073 (May 8, 1984).

\textsuperscript{207} Treas Reg § 1.351-1(a)(2), ex (1).

\textsuperscript{208} See Rev Proc 74-36, 1974-2 CB 491.

\textsuperscript{209} See Rev Proc 83-59, 1983-2 CB 575.

\textsuperscript{210} See Rev Proc 83-59, supra note 209; Ltr Rul 9710018 (Dec 5, 1996).

\textsuperscript{211} IRS Field Service Advice 200149019 (Aug 31, 2001).

\textsuperscript{212} Know-how is discussed in Rev Rul 71-564, supra note 67, and Rev Proc 69-19, 1969-2 CB 301.

\textsuperscript{213} See Ltr Rul 8502024 (Oct 15, 1984). 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.
must be transferred to satisfy the requirements for nonrecognition under Section 351. The question that the IRS asks is whether the transaction, if taxable, would be treated as a sale for tax purposes rather than as a mere license. Thus, under IRS 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.

The courts, on the other hand, have been more liberal. Further, the Clinton administration and the current administration have proposed eliminating the “all substantial rights” requirement, provided that both parties to the transaction treat it in the same manner.

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. Ancillary services rendered by a transferor incident to the transfer of property will typically be disregarded, however, so that no portion of the stock received by the transferor will be viewed as taxable compensation income. Also, when no stock is actually issued to the transferor in exchange, the transfer of intellectual property to a corporation instead may be treated as a tax-free contribution to capital.

Transfers to a Foreign Corporation. If the transferee of intellectual property is a foreign corporation rather than a domestic corporation, the provisions of Section 351 will not protect the U.S. transferor from taxation.

Under Code Section 367(a)(1), to which transfers of copyrights not treated as capital assets are subject, 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.

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. Overturning prior law, this provision, which will apply unless regulations provide to

215. See Rev Proc 83-59, supra note 209, and the preamble to final Treas Reg § 1.861-18 (TD 8785), discussing the “all substantial rights” test.
216. See Del duPont de Nemours & Co v United States, supra note 24, involving a nonexclusive license.
217. 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 225. The same proposal appears in the administration’s Fiscal Year 2001 Revenue Proposals.
218. See IRC § 351(d); Treas Reg § 1.351-1(a)(1)(i); Rev Proc 69-19, supra note 212. Compare Blum v Commr, 11 TC 101 (1948), with Chilton v Commr, 40 TC 552 (1963).
220. See IRC §§ 118, 362(c).
222. See Temp Treas Reg §§ 1.367(a)-1T, 1.367(a)-5T(b)(2), 1.367(d)-1T(b). Note that the provisions of Treas Reg IRC § 1.861-18 apply for purposes of determining the impact of § 367 upon the transfer of a computer program.
the contrary, does not distinguish between transfers of U.S. and foreign intangibles, nor
does it focus on 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 pro-
duce abroad a product for consumption abroad. Moreover, the IRS will seek to apply
this provision under certain circumstances whenever intangibles are simply licensed for
a limited period of time.225

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 productivi-
ty, 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.226
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.227

Under the temporary regulations, however, an election to treat the transaction as a
sale can be made under certain circumstances—for example, when operating intangi-
bles (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 con-
duct 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 percent and
60 percent of the transferee, a newly formed entity, at least 40 percent of which is
owned by unrelated foreign persons.228 The taxpayer then will be taxed at ordinary
income rates on the built-in gain, which, under the temporary regulations, will be treat-
ed as U.S.-source income.

Although mere contributions to the capital of a domestic corporation may be tax
free, contributions to the capital of a foreign corporation normally will be taxed.229 If
the 80 percent 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 corpo-
racion equal in value to the property transferred.230 Otherwise, under current law, the
transferor will be required to include any built-in gain in his or her U.S. gross income,
as though the property had actually been sold, if so provided in regulations promulgat-
ed by the IRS.231

Prior to the Taxpayer Relief Act of 1997, different rules applied. Built-in gain was
taxable at 35 percent 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.232 For failure to file a return reflecting such a contribution made

224. See Temp Treas Reg §§ 1.367(a)-1T(d)(5)(i), 1.367(d)-1T(b).
225. See Temp Treas Reg § 1.367(d)-1T(g)(4)(ii).
226. See Temp Treas Reg. § 1.367(d)-1T(c)(3).
228. Temp Treas Reg §§ 1.367(a)-1T(d)(5)(ii), 1.367(d)-1T(g)(2).
229. See Rev Rul 64-155, 1964-1 (pt. 1) CB 138; Ltr Rul 9343009 (July 21, 1993). See also Nestle Holdings v
Commr, TCM 1995-444, remanded (on a different issue), 152 F. 3d 83 (2d Cir 1998), in which the taxpayer sought to
treat a sale as in part a capital contribution.
230. See IRC § 367(c)(2), reversing the position taken in Abegg v Commr, 50 TC 145 (1968).
231. IRC § 367(f).
232. IRC §§ 1491, 1492(1) and (2)(A), as in effect prior to Aug 5, 1997.
after August 20, 1996, a penalty equal to 35 percent of the gross reportable amount could have been imposed. \textsuperscript{233} To avoid the 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 Code Section 1057 (also repealed by the Taxpayer Relief Act of 1997) to include any gain in his or her U.S. gross income, as though the property had actually been sold. \textsuperscript{234}

Reporting requirements apply to transfers of intellectual property made by a U.S. person to a foreign corporation that are not viewed as taxable contributions to capital, and there are significant penalties for failure to comply—i.e., the lesser of $100,000 (applicable absent intentional disregard of the law) or 10 percent of the value of the property transferred. \textsuperscript{235}

**Using a Foreign Partnership**

Under the law in effect prior to the Taxpayer Relief Act of 1997, a U.S. citizen, resident, corporation, partnership, estate, or trust that contributed property to a foreign partnership was taxed at 35 percent on the built-in gain, notwithstanding the provisions of Code Section 721 that impose no tax when a taxpayer transfers property to a partnership in exchange for an interest in that partnership. \textsuperscript{236} 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 percent voting control requirement of Section 351. \textsuperscript{237}

Under current law, (1) by regulation, rules comparable to those in Section 367(d) may apply or (2) immediate gain recognition will be required to the extent provided in regulations promulgated by the IRS if gain would otherwise be recognized later by a non-U.S. person. \textsuperscript{238} 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, although it appears that the statute as worded gives the government the authority to require immediate gain recognition.

In addition, the reporting requirements under Code 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 percent 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. \textsuperscript{239} The penalties for noncompli-
ance are substantial. First, there is a monetary penalty equal to the lesser of $100,000 (applicable, absent intentional disregard of the law) or 10 percent of the value of the property transferred. Second, the transferor will be required to include in gross income any unrealized gain inherent in the property.

**Being Aware of Code Section 482**

**General.** Code Section 482 broadly states that the IRS 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. The IRS 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. 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. The IRS need not establish fraud, improper accounting, or tax avoidance.

Should the Section 482 adjustment made by the IRS be substantial (that is, for any year beginning after 1993, the price shown on a return is at least 200 percent more than or 50 percent 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 percent of the taxpayer’s gross receipts), the taxpayer may be subject to a 20 percent (or 40 percent, in the case of a gross valuation misstatement) accuracy-related penalty under Code Section 6662. There are actually two types of Section 482 penalties under this provision—a “transactional penalty” and a “net adjustment penalty.” The former penalty applies when a transaction between persons described in Section 482 involves a pricing misstatement. The latter net adjustment 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. The net adjustment penalty cannot be avoided under the general statutory exception for reasonable cause, however.

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240. For a case dealing with the control requirements of § 482, see WL Gore & Associates, Inc v Commr, TCM 1995-96.

241. See generally the IRS’s Foreign Controlled Corporation Non-CEP Transfer Pricing Audit Guide, made available in 1998, and IRS Pub No 3218, Report on the Application and Administration of Section 482.

242. See TAM 9222005 (Jan 10, 1992), in which the IRS took the position that IRC § 482 can apply even to cross-licensing arrangements to which the like-kind exchange provisions of IRC § 131 apply.

243. Treas Reg §§ 1.482-1A(b)(1), 1.482-1(b)(1).

244. Treas Reg § 1.482-1(d)(1).


246. See Treas Reg § 1.6662-6(a)(1).

247. For a recent case in which the 40 percent penalty imposed as the result of a trademark adjustment was reversed on appeal, see DHL Corp v Commr, 285 F. 3d 1210 (9th Cir 2002).


249. See IRC §§ 6662(e)(3)(D), 6664(c). Cf Treas Reg § 1.6662-6(b)(3); Temp Reg § 1.6664-4T(f).
Super-Royalty Provision. The old regulations under Section 482 included a section dealing specifically with the transfer or use of intangible property by a controlled taxpayer.\footnote{250} 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 in a transaction involving controlled taxpayers, the income earned must be commensurate with the income attributable to the intangible.\footnote{251} This is the so-called “super-royalty” provision. 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.\footnote{252} 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.\footnote{253} Further, 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.\footnote{254}

More generally, under the final regulations, one of four methods must be applied to determine whether the consideration for an intangible satisfies the general arm’s-length standard: the so-called comparable uncontrolled transaction (CUT) method, the comparable profits method (CPM), the profit split method, or any other method (an unspecified method) that satisfies the criteria set forth in the regulations.\footnote{255} 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.\footnote{256} A taxpayer is required to choose the method that 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.\footnote{257} Consistent with this approach, the final regulations generally view the comparable profits method as a method of last resort.\footnote{258}

Cost-Sharing Arrangements. 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.”\footnote{259} A cost-sharing arrangement is a written arrangement pursuant to which two or more members of a controlled group agree on 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\footnote{260} in that once the property is developed, each party

\begin{itemize}
\item \footnote{250}{Treas Reg § 1.482-2A(d), applicable in taxable years beginning on or before Apr 21, 1993.}
\item \footnote{251}{With respect to the ownership of intangible property for IRC § 482 purposes, see Treas Reg § 1.482-4(f)(3); Medieval Attractions NV v Commr, TCM 1996-455.}
\item \footnote{252}{See Treas Reg § 1.482-4(f)(4).}
\item \footnote{253}{See Treas Reg §§ 1.482-4(f)(2) (dealing with periodic adjustments), 1.482-4(f)(5) (dealing with lump-sum payments).}
\item \footnote{254}{See Treas Reg § 1.482-4(f)(1).}
\item \footnote{255}{Treas Reg § 1.482-4(a).}
\item \footnote{256}{See Treas Reg § 1.482-1(e).}
\item \footnote{257}{Treas Reg § 1.482-1(c); see, eg, Treas Reg § 1.482-4(c)(2)(i).}
\item \footnote{258}{See Treas Reg § 1.482-5; TD 8552, 1994-2 CB 93, at 109.}
\item \footnote{259}{HR Rep No 99-841 (vol II), 99th Cong, 2d Sess II-638 (1986).}
\item \footnote{260}{See Treas Reg § 301.7701-3.}
\end{itemize}
bears the costs of producing and marketing its interest in the property and retains the benefits of its own efforts. According to the Conference Report on the 1986 legislation, a cost sharer must bear its portion of the costs of developing both successful and unsuccessful products at all relevant stages of development.261

In January of 1992, the Treasury Department issued a proposed regulation262 on the subject of cost-sharing arrangements that incorporated the commensurate-with-income standard and that has since been finalized.263 Under the final cost-sharing regulation, the IRS will not disturb the way in which the parties to a cost-sharing arrangement agree to share the costs of developing intangibles, as long as their agreement qualifies under the standards set forth in the regulation and the IRS 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.264

262. Prop Treas Reg § 1.482-2(g). For the prior regulation on the subject first adopted in 1968, see Treas Reg § 1.482-2A(d).
264. See IRS Field Service Advice 200001018 (Jan 7, 2000), discussing a cost-sharing arrangement. Cost-sharing payments for the right to the use of intangibles have been held to be ineligible for IRC § 174 treatment. See IRS Field Service Advice 200122005 (Feb 1, 2001). In addition, research or experimental expenditures covered by cost-sharing payments are not eligible for IRC § 174 treatment. See IRS Field Service Advice 200207012 (Nov 13, 2001).